

96-104

**INSTALLMENT SALES REVISION ACT OF
1980 AND MINOR TAX BILLS**

HEARING
BEFORE THE
SUBCOMMITTEE ON
SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
NINETY-SIXTH CONGRESS

SECOND SESSION

ON

H.R. 6883	H.R. 6140
H.R. 5616	H.R. 6247
H.R. 5729	H.R. 6824
H.R. 6039	H.R. 7009

APRIL 17, 1980

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INSTALLMENT SALES REVISION ACT OF 1980 AND MINOR BILLS

THURSDAY, APRIL 17, 1980

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

The subcommittee met at 9:30 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the subcommittee) presiding.

[Press release announcing hearing follows:]

[Press release of Apr. 2, 1980]

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A PUBLIC HEARING ON H.R. 6883, INSTALLMENT SALES REVISION ACT OF 1980, AND ON SEVERAL MINOR TAX BILLS, TO BE HELD ON APRIL 17, 1980

The Honorable Dan Rostenkowski (D., ILL.), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will conduct a public hearing on the Installment Sales Revision Act of 1980, and several minor tax bills, on Thursday, April 17, 1980. The hearing will be held in 1100 Longworth House Office Building, the Committee's main hearing room, beginning at 9:30 a.m.

The agenda for this hearing is as follows:

INSTALLMENT SALES REVISION ACT OF 1980

H.R. 6883 (Mr. Ullman, Mr. Conable, Mr. Rostenkowski and Mr. Duncan of Tennessee).

To amend the Internal Revenue Code of 1954 to revise the rules relating to certain installment sales.

Background.—On July 27, 1979, the Subcommittee on Select Revenue Measures held hearings on H.R. 3899, to amend sec. 453(b) of the Internal Revenue Code of 1954 to simplify the rules relating to certain installment sales. As a result of suggestions and comments received at that hearing, the staff was directed to develop a revised bill to reflect appropriate changes to simplify and improve this area of the tax law by taking into account the comments and testimony received. In developing the revised bill, the staff worked closely with the Treasury Department, the tax section of the American Bar Association and the federal tax division of the American Institute of Certified Public Accountants.

Witnesses testifying on H.R. 6883 are, therefore, requested to focus their comments exclusively on the revised legislation.

MINOR TAX BILLS

H.R. 5616 (Mr. Coelho, et al)—To preserve the existing tax status of wine used in the production of distilled spirits.

H.R. 5729 (Mr. Conable)—To amend the Internal Revenue Code of 1954 to provide for the amortization of startup expenditures paid or incurred in starting a new trade or business.

H.R. 6039 (Mr. Lederer)—To provide that annuity contracts purchased by the Uniformed Services University of the Health Sciences shall be entitled to the benefits of section 403(b) of the Internal Revenue Code of 1954.

H.R. 6140 (Mr. Ullman, Mr. Rostenkowski and Mr. Conable)—To prevent the abuse of certain pension plan provisions of the Internal Revenue Code of 1954 through the use of separate corporations or other organizations.

H.R. 6247 (Mr. Gibbons)—To amend the Internal Revenue Code of 1954 to provide that in certain cases where married individuals live apart community property laws will not apply for Federal tax purposes.

H.R. 6824 (Mr. Cotter)—To preserve the application of existing law to non-qualified deferred compensation arrangements maintained by tax-exempt organizations.

H.R. 7009 (Mr. Rostenkowski, et al)—To amend section 117 of the Internal Revenue Code of 1954 to provide that Federal grants for tuition and related expenses at institutions of higher education shall not be includible in gross income merely because the recipient is required to render future service as a Federal employee.

Leadoff witnesses at the hearing will be representatives of the Treasury Department followed by Members of Congress and those from the general public who have requested to be heard.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

The limited time available to the subcommittee for this hearing requires that all persons and organizations having a common position designate one spokesman to represent them. Each witness must summarize his or her statement with the understanding that the detailed statement will be included in the printed record of the hearing. The time allowed witnesses for the presentation of oral testimony will be strictly limited. If necessary, staff will group public witnesses into panels to expedite the hearing process. Any persons or organizations desiring to do so may file a written statement for inclusion in the printed record of the hearing instead of appearing in person, in accordance with the directions outlined below.

The cutoff date for requests to testify is the close of business on Monday, April 14, 1980. Requests to be heard, therefore, should be submitted by telephone to John M. Martin, Jr., Chief Counsel, Committee on Ways and Means, 1102 Longworth House Office Building, Washington, D.C. 20515, telephone: (202) 225-3625.

Requests to be heard must contain the following information:

(1) The name, address, telephone number and capacity in which the witness will appear;

(2) A listing of clients (or the firm or association represented) at whose request or in whose employ the witness is appearing;

(3) Which bill or bills will be discussed, whether in support or opposition; and

(4) A summary of testimony to be presented.

Notification to those scheduled to appear will be made by telephone promptly after the filing deadline. If a witness cannot appear on the day scheduled, he may wish either to substitute another spokesman in his place or file a written statement for the record of the hearing instead of appearing in person. In any event, if a change in the scheduled witness or cancellation is necessary, please advise the Committee office immediately.

Witnesses should submit 50 copies of their prepared statements to the Committee office, 1102 Longworth House Office Bldg., at least 24 hours in advance of the hearing. An additional supply may be furnished on the date of appearance for distribution to the press and public.

WRITTEN STATEMENT IN LIEU OF PERSONAL APPEARANCE

Instead of appearing in person, written testimony may be submitted for the consideration of the Subcommittee and inclusion in the printed record of the hearing. For this purpose, five copies of the statement should be submitted by the close of business on Friday, April 25, 1980. If those filing for the record want copies of their statement distributed at the hearing to the members of the Subcommittee, press and public, additional copies for this purpose should be delivered to 1102 Longworth House Office Building before the hearing begins.

Mr. ROSTENKOWSKI. The subcommittee will come to order.

This morning's hearing is another in a series undertaken by the subcommittee to consider changes in the Federal tax law. The bills before us today present several substantive issues for our consideration. Among them is the revision of tax rules for installment sales.

H.R. 6883, the Installment Sales Revision Act of 1980, was developed as a result of comments received in connection with an earlier bill, H.R. 3899, which was introduced last year. After the subcommittee's hearing on H.R. 3899 last July, a number of modifications to the bill were suggested which would simplify and improve this complex area of the tax law.

Therefore a revised bill was developed by the staff, working in close conjunction with the Treasury Department, the American Bar Association, the American Institute of Certified Public Accountants and various other experts in this field. I hope this revised bill receives the careful consideration from witnesses which it deserves.

In addition to this important area of proposed change, we will also be examining other significant issues this morning such as those raised in H.R. 6140 and H.R. 7009. H.R. 6140 addresses abuses arising under certain pension plan provisions of current tax law through the use of separate corporations and other entities.

H.R. 7009 provides a permanent tax rule for recipients of Federal scholarships whose award is conditioned upon the performance of future service as a Federal employee.

These bills concern areas which Congress has in the past accorded unique treatment by establishing special rules. They deserve the particular attention of this subcommittee.

We will begin this morning with presentations by two Members of Congress who are sponsors of two of the bills being considered at this hearing. Then we will hear from representatives of the Department of the Treasury, to be followed by public witnesses who have expressed an interest in appearing before the subcommittee.

I want to remind the witnesses that each has been given a limited amount of time for oral presentation. As a result, all are encouraged to summarize their prepared statements, which will be included in their entirety in the hearing record.

Our first witness is the distinguished Member of Congress from the State of Florida and certainly a distinguished member of the Committee on Ways and Means. Mr. Gibbons, welcome to the Subcommittee on Select Revenue Measures.

STATEMENT OF HON. SAM M. GIBBONS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. GIBBONS. Thank you, most distinguished chairman.

Mr. Chairman, last year or early this year I introduced H.R. 6247. This legislation is badly needed to cure an injustice that occurs in community property States. I think I need not explain what community property States are and how they differ from common law States, but essentially you know that in community property States both spouses in a marriage are presumed to share the income and, of course, share the tax. This system doesn't work, though, where the spouses are separated and living apart, have to file an income tax return but don't cooperate.

This situation creates a grievous problem. In most cases what we have is the wife of the marriage living separate and apart from her husband. Usually she doesn't know where he is and can't find him and can't make him work and can't make him do anything for her and she really has no benefit in the community property as it exists.

Under my bill, if she does not receive any benefit from the husband's earned income, either directly or indirectly, then she would not have to report it on her tax return. That is essentially all the bill does.

I understand that the Treasury is not opposed to it. There are some people who want to make my bill a little more improved than it is, so I will be glad to answer any questions and turn in my full written statement for the record.

[Mr. Gibbons' prepared statement follows:]

STATEMENT OF HON. SAM M. GIBBONS, A REPRESENTATIVE IN CONGRESS FROM THE
STATE OF FLORIDA

On January 22, 1980 I introduced H.R. 6247, legislation which is badly needed to cure a grievous injustice under present law when separated spouses reside in community property states, file separate tax returns, but do not share their community income equitably. In this situation, each spouse is required to report the one-half of community income attributable to the income and earnings of the other spouse, whether or not such income is in fact received. H.R. 6247 will correct this problem by providing that separated spouses will be taxed only on the real economic income earned or received by each, and not on a share of community income not actually received.

The Administration indicates that it will support H.R. 6247, along with several public interest organizations concerned with the fairness of our tax laws as they are applied to married persons. The revenue effect of my bill is insignificant. Indeed there has rarely been a more convincing case for the passage of remedial legislation.

Typically, the worst cases under present law have involved an unsupported wife who does not know, and has no way of knowing, the financial status and affairs of the community or even the whereabouts of her husband. In many cases, no return has been filed or tax paid by the absent husband. In this situation, the wife has no control over her statutory income tax liability and no means to compel her husband to divulge information for tax filing purposes concerning the community's assets, liabilities, or income. As a practical matter, the wife filing separately can neither prepare a return showing the community income nor pay the tax on such income, despite her legal requirement to do so. In many cases, the final result of imposing a tax liability on the separated wife for the one-half of the community earnings of the husband is to create an uncollectible deficiency. Despite the availability in most community property states of a suit for separation of property, the wife is, as a practical matter, helpless if the husband cannot be located for service of process.

Both the Tax Court and the United States Supreme Court have invited Congress to enact remedial legislation such as I have introduced. They suggested that community be dissolved for tax purposes where a separated spouse receives no financial benefit from the community earnings of the other spouse. This problem was first brought to the attention of the Congress in July 1977 by the General Accounting Office in a letter report to the Joint Committee on Taxation. The GAO recommended that, where certain conditions exist, the separated spouse who does not receive the one-half of community income to which he or she is entitled be relieved of tax liability with respect to such income. The conditions specified by the GAO were: (1) the separated spouse files a separate return; (2) he or she lives apart from the other spouse for the entire taxable year; and (3) he or she has not received, directly or indirectly, any of the community income omitted from gross income. The conditions are incorporated in the bill's new section 66 of the IRC which refers to section 879(a) for the applicable tax computation rules.

It has come to my attention that several of the witnesses scheduled to review H.R. 6247 for this Subcommittee today will make recommendations for ways to

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improve the bill. I support these efforts, but I want to make it clear that I would not want to jeopardize this opportunity to remedy the most clear cut cases of abuse. The most serious inequity is the taxation of a separated spouse on the earned income of the other spouse from which he or she derives absolutely no benefit. I await with interest what these other witnesses have to offer in the way of improvements.

This legislation would improve the equity of our Federal tax laws for separated spouses and I am hopeful that this bill will receive the support and expeditious consideration that it deserves.

Mr. ROSTENKOWSKI. Thank you. I can say only that any legislation that Mr. Gibbons introduces, I am sure, is very difficult for us to improve upon, but if we can, we certainly will.

Mr. GIBBONS. You leave me speechless.

Mr. ROSTENKOWSKI. Who knows, I might have something before your subcommittee in a short while.

Mr. GUARINI. There is only one area I would like to ask your opinion on, Sam. We know that the public policy dictates that marriages should be encouraged and family unity should be encouraged and that this committee has been criticized for its lack of vision when we pass laws in not understanding how many women would be working, so that more families are involved than was anticipated when the rules were originally passed.

Now, I can understand the delineation on the income tax form, which makes sense, and we all agree with your philosophy. I am wondering whether or not we should actually even think about philosophically carrying it a little further. If you have a separation of income of people during their working life, what about if they do get divorced? Should we keep the income and the investments separate?

It would make for fewer sticky divorces and there would be fewer court actions and there would be less fighting between spouses when they get a divorce. Also, when you have estates, instead of the Government's getting the short end of it and arguments taking place as to who owned what and the income being mixed and not earmarked and the investments not being earmarked, should we delineate the complete investments and income and net worth of the people as well as the earned income so that for all legal purposes we could keep track of who owns what and what taxes would accrue to the U.S. Government?

Mr. GIBBONS. Mr. Guarini. I hope some day we can pass a law here in Congress that will allow us to quit worrying about interspousal transfers where the spouses are living together and where it is obviously not done to defraud the Government. I think all of the record-keeping we cast upon families is ridiculous. There is not a lot of money involved in it, and I think that to tax a family's estate once at the death of the husband and then again at the death of the wife—or, in the reverse, in the event of the death of the wife and then the death of the husband—is excessive. Unfortunately we are wasting some of the best brains in America trying to figure out the marital deduction and how to beat that unfair law.

Most families never dream they are going to get into inheritance tax and estate and gift tax laws and they don't keep records to show who paid for what or how it was paid for. It was really paid for by their joint efforts.

But these points are not germane to the legislation I am proposing here today. My bill is just to take care of the problem that arises in

community property States where spouses are not living together and don't live together during any of the taxable year. This can't be one of these separations that we see on television that occur just for tax purposes. This has to be a real separation. It really comes about because the spouse can't find or can't get the cooperation of the other spouse to get the information to file a tax return.

We have had some ridiculous situations arise in community property States where the IRS has tried to collect, as they are required under the law, funds from a spouse who didn't receive them, had no beneficial use of them and had no knowledge that they even existed. That, I say, is trying to get water out of a stone.

Mr. GUARINI. But there are two areas of concern in income tax. One is with earned income, which is the salaries people are receiving in their jobs. The other is the investments that they have.

Mr. GIBBONS. OK; I understand that.

Mr. GUARINI. I think we are all in agreement concerning the earned income but there is always an area equally involved where you have investments, because you are going to have the same problem because there is money to be reported. Should those investments be kept separately on the tax return or should we solve just the earned income and just let the same problem exist on investment income?

Mr. GIBBONS. It would be simpler for the Government if we limited it to just earned income, but in investment income at least you have an asset that you can go out and find, a thing you can go out and find. You write to General Motors and say: "Listen, I am entitled to part of that dividend; it is mine." Or you can write to a savings and loan and say: "I get part of that interest; it is mine in a community property State." A lawyer can reach that.

But with earned income, that earned income may arise almost anywhere. I don't know how much money it would cost to bring passive income into this picture and I wouldn't want to do anything right now to stop the enactment of this bill as it presently is. If the committee feels that it should bring investment income into this picture I wouldn't oppose it, but I don't know what the amount of money involved would be.

Investment income is a little easier to get at than earned income. And the reason I say that is because in investment income at least you have a thing you can go after—that is, through legal action. But this bill is limited to those situations where the spouses are separate and living apart, not just a Haitian divorce or one of these weekend divorces that people are now trying to get for income tax purposes.

Mr. GUARINI. Thank you very much. In fact, that is quite a business and there are consultants for married people.

Mr. GIBBONS. I think it is one of the things we ought to straighten out with some of that money from the windfall profits tax. I was sitting right back over there when we made that mistake, and I can remember it well.

Mr. GUARINI. Thank you.

Mr. ROSTENKOWSKI. Are there any further questions?

I want to thank you for your presentation. Thank you very much. We are aware of the work you have done on this legislation with the cooperation of your fine subcommittee staff.

Our next witness is Mr. Coelho, a Member of Congress from the State of California. Welcome to the committee, Tony. You may proceed with your testimony on your legislation.

**STATEMENT OF HON. TONY COELHO, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF CALIFORNIA**

Mr. COELHO. I appreciate the opportunity to be here today and I appreciate the fact that you have scheduled this bill for consideration. This bill would preserve the existing status of wine used in the production of distilled spirits. This legislation has become necessary due to an inadvertent provision contained in the Trade Agreements Act of 1979.

Prior to the passage of the Trade Act, wine used in the production of rectified products such as brandies and cordials was taxed at the regular rate for wine. The fact that it was used in the production of another product did not alter its tax status. However, an unintended result of a provision in the Trade Act inadvertently affected the tax status of such wine.

During consideration of the trade bill by the Congress the wine industry and Members of the California delegation were assured that while the trade bill did not provide any benefits or concessions in foreign markets for domestic wine, there were indeed no adverse effects on the domestic wine industry.

I might add at this point that these assurances were given to the California delegation by Ambassador Strauss, and he made that point very emphatically that we would not get hurt in any way, and we believed that, and it was not a concern of ours.

Such assurances were provided by those who had negotiated the trade bill for the United States.

Yet, as the bill was being brought to the House floor for consideration—on the very day it was being brought to the House floor, it was discovered that a provision in the bill altering the tax method of computation for alcoholic beverages would in fact substantially increase the tax rate on wine used in rectified products.

This point was raised with our colleague and a member of the Ways and Means Committee, Charlie Vanik, who was handling the trade bill on the floor. His comments on the floor of the House at that time were that "the result was never intended by our committee" and that "we have just become aware of this unintended impact on the wine industry."

Furthermore, letters attesting to this unintended impact have been provided by those who negotiated the trade bill and I understand they have been, or will be, submitted for the record.

Mr. Chairman, those of us in the California delegation who are concerned with the vitality and growth of our domestic wine industry look upon H.R. 5616 as remedial legislation. It does not provide any new or special benefit for this industry. It merely corrects an unintended and potentially harmful provision of the trade bill.

I thank you again for the opportunity to testify this morning, and for your consideration of this important legislation.

Mr. ROSTENKOWSKI. Mr. Coelho, the Flavor and Extract Manufacturers Association has asked to testify with regard to this legislation and they have a similar problem. Would you have any objection if this committee in its wisdom felt that we could correct that problem as well, and attach it to your legislation and solve both problems at the same time?

Mr. COELHO. I have no objection at all and the California delegation would not object. Our only concern, and I am sure you would recognize this, is that the Senate has basically passed the language of my bill and we would hope that any additions to this legislation would not slow the process down so that this bill could get into law to prevent the collection of the taxes.

I think the matter of flavoring should be rectified and should be taken care of and so I would like to be able to participate in the correction of both problems.

Mr. ROSTENKOWSKI. Thank you. Thank you very much.

Mr. Dan Halperin and Mr. Gutman, welcome to the subcommittee. Gentlemen, we are looking forward to your observations on the legislation that we are considering today.

STATEMENTS OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION) AND HARRY L. GUTMAN, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. HALPERIN. Mr. Gutman will speak to the Treasury's position on the installment sale bill. My testimony deals with several of the other matters before us this morning.

As far as the two bills which you have heard discussed so far this morning, as Mr. Gibbons indicated, we do support his legislation, H.R. 6247. It deals with the most dramatic causes of unfairness under present law and we have suggested that one could go a little bit further in relieving these problems than he has suggested without getting into trouble.

It is difficult to solve the problem completely as long as we do not tax people on their own earnings without regard to joint returns or community property status. However, we think we can deal with the most serious cases and we support Mr. Gibbons' bill, H.R. 6247.

With respect to the question of the taxation of wine and liquors raised by H.R. 5616, as you know the main responsibility for that within the Treasury Department is with the Bureau of Alcohol, Tobacco, and Firearms. We in tax policy are certainly not expert on this subject, and I don't want to get into a debate as to what people were told or were not told.

I am assured, however, that the 1979 changes in the treatment of wine used in distilled spirits products was not an unintended result. We have included in our testimony a specific quotation from the Ways and Means Committee report on the Trade Act of 1979, which specifically states that when wine is added to a distilled spirit it will be taxed at the distilled spirit rate.

Apart from what was intended, the position of the Treasury Department is that the alcoholic content in liquor ought to be taxed at the same rate whether it comes entirely from liquor or includes wine.

We also believe there are serious enforcement problems under the bill. One of the purposes of the Trade Act of 1979 was to eliminate as far as possible nontariff barriers to trade by taxing imported liquor on the same basis as domestic liquor. We are told that in order to try to figure out what kind of refund would be allowable or what kind of reduced rate would be allowable on imported liquors under the bill, it would be necessary to determine how much wine is in the finished product and what the alcohol content of that particular wine is. That is impossible to do by laboratory analysis.

Therefore, the Bureau of Alcohol, Tobacco, and Firearms is concerned about the potential abuse in these provisions. For these reasons, the Treasury has opposed H.R. 5616.

I would like to concentrate this morning on two bills, H.R. 6140, which we have supported, and H.R. 6824, which we oppose. They both concern the same problem. They concern the issue of protecting the incentive to establishing qualified retirement plans which provide pension benefits for rank and file employees. We feel quite strongly that the purpose of the qualified plan rules is to assure that there is broad coverage of employees; that pension benefits are provided for people at all income levels. To achieve this, the tax system offers an incentive for people to establish plans.

A tax incentive works in the case of high paid employees who already have an incentive to save and for whom the tax savings are very meaningful. However, it doesn't mean much to low-paid employees who have more problems with savings in the first place and for whom the tax savings is less important.

Therefore, it is in effect an upside-down provision: those who need the incentive the most get the least. However, qualified plans deal with this problem by requiring coverage of people at all income levels. What we are worried about in these bills is maintaining that incentive.

In order to maintain the incentive for qualified plans we have a system of taxation which provides that if you want to get a current deduction by the employer without any tax being paid by the employee until retirement, and if you want tax exemption for the investment income of the fund, you generally must set up a qualified plan.

That is ordinarily the only way to get these three benefits, a current deduction for the employer while the employee pays no tax, and a tax-exempt investment fund. Tax-exempt organizations, of course, are not interested in the deduction for the employer. They are only interested in the remaining two elements and those can be achieved without a qualified plan.

First, if they do not fund the plan, then, under our current system of taxation, employees are not taxed even if they have a vested interest as long as there is no separate fund set apart for their benefit.

Second, tax-exempt organizations are not taxable on their own income. So if you have an executive of a trade association or a doctor working for a tax-exempt hospital, that person can say to his employer:

Don't pay me part of my salary, just keep it, hold on to it and invest it in the stock market and I will tell you where to put it and how to invest it. Just keep it back and pay it to me after retirement.

It is hoped and expected that such a method avoids current tax since the assets are nominally held by the tax-exempt organization.

There is also no tax on the earnings. That leads to two problems. First of all, under ERISA, rank-and-file employees even if they were interested in that kind of arrangement, could not participate in it. We have in the law a requirement that plans that favor rank-and-file employees be funded. Therefore, they could not take advantage of this tax-saving arrangement.

Second, the ability to provide tax benefits or tax-favored retirement benefits for high-paid employees without including low-paid employees eliminates the incentive to establish a qualified plan which would benefit all levels of employees. In order to deal with this problem, 2 years ago the Treasury and the IRS issued proposed regulations which would have taxed employees currently when they had the choice to receive the money currently. H.R. 6824 would preclude the issuance of these regulations. We can see the advantages of a legislative solution as opposed to a regulatory solution in this area but we insist that any legislation must contain appropriate limits on amounts that can be set aside and must retain the incentive for these organizations to establish qualified plans.

For these reasons, we have opposed H.R. 6824.

On the other hand, we support H.R. 6140 because it does thwart efforts to accomplish similar goals. The goal again here to limit the tax-favored retirement savings to the top-paid employees. Since we are dealing with taxable organizations in H.R. 6140, they need the qualified plan, but what they have tried to develop is a ploy to keep the rank-and-file employees out of the qualified plan by pretending not to hire any of them.

We have set forth on page 11 of my testimony an example where we refer to Smith and Jones in the practice of law. They could form a professional corporation to practice law but if they do so they must provide pension coverage for their associate lawyers, for their secretaries and for their receptionists. If they want to avoid this, if they aren't interested in providing pension benefits for any of these people, the law firm won't have a pension plan.

However, that leaves Smith and Jones out and they want the pension coverage for themselves. They conclude that they can't work for the law firm. So they form their own professional corporations, Smith Professional Corp. and Jones Professional Corp., and these corporations have only one employee, Smith and Jones, respectively. Each corporation sets up qualified pension plans with the maximum possible benefits for its one employee.

Then the corporations become partners in the law firm. The law firm doesn't employ Smith or Jones but it employs Smith Corp. and Jones Corp. This is obviously nonsense. Congress was aware of these games and in 1974, in ERISA, it prevented the simple method of achieving this result. The simple method involves establishing a parent and a subsidiary corporation, where the parent hires the management employees and has a pension plan, and the subsidiary hires the rank and file employees and does not have a pension plan.

That specifically is precluded by ERISA. However, for technical reasons, that specific provision in ERISA is not applicable to the

Smith and Jones case. One would have hoped that the courts could see through such a transparent arrangement. However, the Tax Court has not chosen to do so and therefore legislative changes are necessary and appropriate.

We support H.R. 6140 which curbs the most obvious abuse in this area. We have suggested that the legislation be broadened. As it is now written, it covers only professional corporations. If the same kind of arrangement is worked out in a retail store, the legislation would not cover it. We recognize that the professionals are ahead in practicing this kind of abuse, but we see no reason why others will not follow and, therefore, we suggest that the legislation be extended to cover these other cases.

We have also pointed out in our testimony possibly more sophisticated ways of accomplishing the same result. We hope to explore with the subcommittee and with the staff methods of dealing with these other abuses but for the moment we suggest that H.R. 6140 not be held up. It is needed legislation and it should go forward while we work on the additional problems.

That concludes my testimony and I will be glad to answer any questions, or you might want to hear now from Mr. Gutman on installment sales.

[The prepared statement follows:]

STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION), DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to present the views of the Treasury Department on the following six bills: H.R. 5616, relating to the excise tax on wine used in distilled spirits products; H.R. 5729, allowing a deduction for new trade or business start-up expenditures; H.R. 6039, relating to the treatment of annuity contracts purchased by the Uniformed Services University of the Health Sciences; H.R. 6140, to prevent the abuse of certain pension plan provisions through the use of separate corporations or other organizations; H.R. 6247, to provide that, in certain cases where married individuals live apart, community property laws will not apply for Federal tax purposes, and H.R. 6824, to provide for the treatment of non-qualified deferred compensation arrangements maintained by tax-exempt organizations. These bills as a group raise a number of significant tax policy issues and we commend the Subcommittee for providing this opportunity to discuss the issues.

After setting out a summary and the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

SUMMARY

H.R. 5616 would reduce the effective excise tax rate on wine used in distilled spirits products to its pre-1930 level. The Treasury Department is strongly opposed to H.R. 5616.

H.R. 5729 would permit a taxpayer to elect to amortize certain business start-up costs that otherwise would not be deductible. The Treasury Department supports H.R. 5729.

H.R. 6039 would extend section 403(b) treatment to annuity contracts purchased by the Uniformed Services University of the Health Sciences. The Treasury Department is not opposed to H.R. 6039.

H.R. 6140 would require employees of entities providing services to professional corporations to be included in qualified retirement plans established by such professional corporations. The Treasury Department supports H.R. 6140 and suggests consideration be given to a broader solution to potential abuses in this area.

H.R. 6247 would provide that community property laws would be disregarded for Federal income tax purposes if spouses live apart for an entire year and no income transfer is made between the spouses. The Treasury Department supports H.R. 6247, modified as described below.

H.R. 6824 would allow employees of tax-exempt organizations to individually elect to defer any amount of compensation without regard to the rules relating to qualified retirement plans. The Treasury Department is strongly opposed to H.R. 6824.

H.R. 5616—TAX STATUS OF WINE USED IN DISTILLED SPIRITS PRODUCTS

H.R. 5616 proposes to reverse one part of the thorough reform of the taxation of distilled spirits enacted as the Distilled Spirits Tax Revision Act of 1979 (Title VIII of the Trade Agreements Act of 1979). Under the 1979 Act, which was effective January 1, 1980, all distilled spirits products, domestic and imported, are taxed on their alcoholic content at a uniform rate of \$10.50 per proof gallon at the time of removal from bond. This was not true of prior law.

One case where the prior tax deviated from a straight \$10.50 rate involved the mixing of wine with distilled spirits to produce a distilled spirits product, most notably liqueurs, cordials, and so-called specialties. The wine was taxed at the low rate on wine when withdrawn from the winery, the distilled spirits used were taxed at the distilled spirits rate when withdrawn from the distilled spirits premises, and the mixture then was subject to an additional rectification tax of 30 cents a proof gallon. The net result was that some domestic liqueurs and cordials containing large amounts of table wine were taxed at an effective rate of \$6.50 a proof gallon. This was true, however, only for domestic products. Imported alcoholic beverages were taxed on the proof gallon content, or wine gallon if below 100 proof. For example, a gallon of 80 proof whiskey imported in bottles was taxed at \$10.50 instead of the \$8.40 it would have been subject to if taxed on the proof gallon content.

H.R. 5616 seeks to restore the prior lower effective rate on the alcoholic content of wine used in distilled spirits products. It would grant the producers, or importers, of distilled spirits products containing wine a credit against the distilled spirits tax equal to the excess of \$10.50 over the tax rate on the wine content that would have been imposed if the wine had been taxed as wine. Depending upon the tax classification of the wine, the credit could be as much as \$9.89 per proof gallon of the wine.¹ For domestic products the credit would be taken at the time wine is dumped for processing at a distilled spirits plant. The credit for imported products would be determined at the time the tax on the imports is determined; i.e., removed from bonded premises.

The Treasury Department strongly opposes enactment of this bill for two reasons. First, the bill would defeat a major purpose of the Distilled Spirits Tax Revision Act of 1979, which is to tax distilled spirits products uniformly on the basis of alcoholic content. Second, the bill would create serious administrative problems in protecting the revenue, particularly with respect to imported products.

The Treasury Department strongly supported the change to taxing distilled spirits products on the basis of their alcoholic content because it believes that it is only reasonable that producers and consumers of all domestic distilled spirits products be taxed on a uniform basis measured by alcoholic content. The fact that part of the alcohol in a distilled spirits product is derived from wine should not be reflected in a lower tax than if the alcohol were produced only from grain. Consumers of liqueurs, cordials, and so-called specialties no longer can obtain the alcohol at a lesser tax rate than highball consumers. Of course, the change caused some increase in the cost of products formerly taxed at less than \$10.50 a proof gallon, but this is a necessary result of the desired objective.

The taxation of alcohol in wine used in distilled spirits products at the distilled spirits tax rate was not an unintended result of the 1979 legislation. The Ways and Means Committee, in reporting on that legislation, expressed support for the all-in-bond system and the resulting changes in the method of determining the tax on distilled spirits as an improvement in the distilled spirits tax system.²

¹ This is as much as 2½ times the cost of the wine to the distilled spirits producer.

² H.R. Rep. 96-317, 96th Congress, 2d session 162 (1979).

The Committee also specifically noted that the new system of taxation would have the result "that domestic products as well as imported products will now be taxed on the basis of the alcohol content of the finished product after it has been diluted and bottled and will include the part of the alcohol content which is derived from *wine or other alcoholic ingredients* added to a distilled spirits product before it is bottled."²

The importance to the domestic wine industry of the changed method of taxing distilled spirits is extremely minor. Wine is not used in distilled products merely to save on the excise tax. Many products contain wine as a basic flavoring ingredient. If the producers do not want to have to educate their customers to a new taste, they will continue to use the same, or approximately the same, amount of wine. There are some products, of course, where wine is heavily used to minimize tax. These formulas might well be changed somewhat under the new law. But whatever the change, it can hardly loom large for the wine industry.

According to our statistics, only 403,000 proof gallons of wine and vermouth were used in domestic distilled spirits products in fiscal year 1979. This represents less than 2 million wine gallons. In the same 1979 fiscal year, withdrawals of domestic still wine, both taxable and tax-free, were 395 million gallons. Use of wine in distilled spirits products thus was about one half of one percent of total withdrawals.

The proposal in H.R. 5616 obviously does not represent a great deal of revenue. For domestic products, the revenue loss appears to be about \$5 million based on recent practice in the industry. We do not have an estimate of how much the revenue loss would be for imported products. Our objection to the bill thus goes beyond the particular revenue figure. The change in the law that resulted in the taxation of distilled spirits products containing wine on a proof gallon basis also taxed on the same basis domestic products containing alcoholic flavoring material and all alcoholic beverages imported at below 100 proof. We consider this equalization as a major step forward. The return to an unequal level of taxation as proposed by H.R. 5616 would represent a step, perhaps the first step, back to a system that is less than equitable. As a matter of fact, the flavoring material producers wish a return to the old system as it affected them if wine producers are granted the change proposed by the bill.

Under prior law, it was possible to reduce the effective rate of tax on distilled spirits products by using a small amount of flavors or flavoring materials containing alcohol taxed at \$1 a proof gallon because they qualified as being "unfit for beverage purposes." If wine producers are to be given a tax advantage as proposed by H.R. 5616, it is hard to argue that producers of flavoring materials should not also benefit from a return to the old system.

Administrative problems posed by the bill would be most apparent in its application to imported products. The tax on wine varies depending on its alcoholic content. For example, the tax on wine which does not exceed 14 percent alcohol by volume is 17 cents per gallon, and the tax on wine over 14 percent but not exceeding 21 percent by volume is 67 cents per gallon. Therefore, in order to determine the credit due on imported products under H.R. 5616, it would be necessary to know both the quantity and alcoholic content of wine used in the product. The laboratory of the Bureau of Alcohol, Tobacco and Firearms has advised us that it is technically impossible to analyze a finished distilled spirits product to determine the quantity and alcoholic content of wine which may have been added. Consequently, there is virtually no way in which ATF could verify claims made by importers under the bill. Since the tax credit in question is almost \$10 per proof gallon of wine our inability to verify claims would pose a serious jeopardy to the revenue.

Any amendment to the bill to eliminate the credit for imports while retaining the credit for domestic products would be inconsistent with the purpose of the Trade Agreements Act, since it would constitute a nontariff trade barrier of the type we have objected to when imposed by foreign countries.

With respect to the credit for domestic distilled spirits products, the bill also presents administrative and technical problems. Presumably, the theory for the credit provision is that the wine will eventually leave the distilled spirits plant taxed at the distilled spirits rate. However, the bill does not require this as a condition to the credit. A credit is allowed regardless of whether the wine is ever

² Id. at 164, emphasis added.

taxed as distilled spirits. In fact, products containing wine could, for example, be exported or destroyed without being subjected to the distilled spirits tax. In addition, the bill permits the credit to be taken at the time the wine is received at the distilled spirits plant, but the tax is not paid until the final product leaves the plant. Thus, the bill provides for the credit before the tax is paid.

Further, one of the major purposes of the Distilled Spirits Tax Revision Act of 1979 was to simplify the tax system and the regulation of distilled spirits plants. However, H.R. 5616 would complicate the administration of the distilled spirits tax by reimposing on distilled spirits producers the requirement to maintain records showing the proportions of wines and distilled spirits in each product and the quantities shipped. It would also create additional oversight problems for ATF and thus diminish one of the chief advantages of the Government from implementation of the all-in-bond system enacted by the 1979 law.

H.R. 5729—AMORTIZATION OF START-UP EXPENDITURES

H.R. 5729 would permit a taxpayer to amortize over a period of five years or longer certain business start-up costs that otherwise would not be deductible. The costs that may be amortized under the bill are those costs paid or incurred prior to the functioning of the business as a going concern and that are incident to the investigation, formation, or creation of a business which is actually entered into by the taxpayer. The costs may not create an asset having a useful life of its own; they must be of a character that would be subject to amortization over the life of the business (and not the life of some other asset) if the business had a determinable useful life. Typical of these costs are the investigatory expenses directly related to the particular business, and the appraisals, advertising insurance, utilities and other routine expenditures paid or incurred prior to the actual commencement of the business.

For the following reasons, we support H.R. 5729.

The bill is designed to reduce the disparity in tax treatment between certain ordinary and necessary preopening expenses and similar expenses incurred by an existing business. Under current law, most preopening expenses are neither deductible nor subject to amortization, but similar expenses incurred by a going concern are currently deductible in most cases. It is difficult to justify such disparate treatment for similar expenses.

The problem of start-up costs arises not only for taxpayers entering their first business, but also for taxpayers with an existing business upon beginning a new business that is unrelated or only tangentially related. The tax treatment of the start-up costs of a related business has generated much controversy. Under current law, these costs are currently deductible if the new operations are part of the existing "trade or business" and the costs do not create a separate asset; costs must be capitalized, however, if the new operation constitutes a separate trade or business. The many controversies between taxpayers and the Internal Revenue Service on this issue reflect (1) the difficulty in many cases of determining what constitutes a new business and when a new asset is created, and (2) the consequences of the determination. Depending on where these lines are drawn, the start-up costs are either deductible in full or must be capitalized indefinitely.

It is our hope that enactment of this bill will induce taxpayers with existing businesses to elect to amortize the start-up costs of a marginally related business, thereby reducing the number of controversies in this area. In the unclear cases, of which there are many, taxpayers should elect to amortize; if they fail to elect and the Internal Revenue Service successfully maintains that the costs must be capitalized, the election would not be available and the costs would not be recoverable through amortization.⁴ Electing to amortize these expenses over five years would appear for most taxpayers to be a more prudent decision.

In summary, we support H.R. 5729 because it would (1) reduce the disparity in tax treatment between certain ordinary and necessary preopening expenses and similar expenses incurred by an operating business, and (2) tend to reduce the number of controversies between taxpayers and the Internal Revenue Service, especially where a taxpayer begins a related business.

⁴ This is based on the assumption that the bill is clarified to require that the election must be made not later than the time prescribed by law for filing the return (including extensions thereof) for the year the expense was paid or incurred. A provision of this nature would be necessary, in our view, to achieve one of the major virtues of this bill.

H.R. 6039—ANNUITY CONTRACTS FOR UNIFORMED SERVICES UNIVERSITY OF THE
HEALTH SCIENCES

Under current law, an employee of a tax-exempt organization described in section 501(c)(3) of the Code, or an employee of a public school system, may participate in a tax-exempt salary reduction annuity plan. In general, employer contributions for the purchase of an annuity contract under such a plan are excludable from the employee's gross income and are not subject to tax until the employee receives payments under the annuity.

H.R. 6039 would extend the availability of these tax-exempt salary reduction annuity contracts to the civilian faculty and staff of the Uniformed Services University of the Health Sciences. We understand that the bill is intended to allow this University to attract civilian faculty and staff by offering retirement benefits and salary reduction plans similar to those given to the faculty and staff of medical schools which are tax exempt or which are part of a public school system.

H.R. 6039 is substantially identical to a number of bills which have been introduced in this and the previous session of Congress. As we have previously testified, the Treasury Department does not believe that section 403(b) represents sound tax policy. However, in the context of present law, the Treasury Department does not oppose H.R. 6039.

We do request a change in the effective date of the bill, however. H.R. 6039 provides that it will apply to service performed after December 31, 1979, in taxable years ending after such date. We do not believe it is appropriate to provide for a retroactive effective date, and we suggest revising H.R. 6039 so that it is effective with respect to services performed after the date of enactment in taxable years ending after such date.

H.R. 6140—AGGREGATION OF PROFESSIONAL ORGANIZATIONS FOR RETIREMENT PLAN
QUALIFICATION

H.R. 6140, which we support, is concerned with efforts by some individuals to avoid qualified plan coverage of rank-and-file employees. This is ostensibly achieved by establishing two entities, one which employs a limited number of key employees and another which employs the rank and file. Only the key employee entity adopts a qualified retirement plan.

Before enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), it may have been possible to achieve this result merely by creating two or more corporations within a controlled group of corporations and establishing a qualified plan for employees of only one member corporation. For example, if a manufacturing company established a parent corporation which employed only management employees and a wholly-owned subsidiary which employed all others, a plan could have been adopted by the parent corporation solely for the management employees.

ERISA amended the Internal Revenue Code to prevent this abuse by requiring an aggregation of controlled group members for purposes of testing the qualified status of any plan adopted by a member of the group. In other words, for qualified plan purposes, the employees of all members of a controlled group of corporations are treated as if they were employed by a single employer; in effect, a fictional umbrella employer is assumed.

The legislative history of these rules shows they were intended to "make it clear that the coverage and antidiscrimination provisions cannot be avoided by operating through separate corporations instead of separate branches of one corporation."⁵

However, it is now apparent that the current rule alone will not prevent outright avoidance of Congressional intent in this area.

Description of problem

A body of practice is developing which is aimed at excluding rank-and-file employees from coverage in qualified plans. One approach is to arrange the ownership of related entities in an artificial manner so as to avoid the literal definition of a controlled group. Another approach is to contract with an unrelated "service corporation" to supply non-management or non-professional personnel. For quali-

⁵ H.R. Rep. 93-807, 93d Congress, 2d session 50 (1974).

ned plan purposes, these individuals are treated as employees of the service corporation rather than the organization for which they actually perform services. Although these schemes are seen particularly in the area of professional corporations, they are not limited to professionals.

AVOIDING CONTROLLED GROUP STATUS

In the area of avoiding the controlled group aggregation rules, the focus by key employee corporations has been on the use of brother-sister entities. Under the Code, businesses in a brother-sister relationship are aggregated for plan purposes only if five or fewer persons own more than 50 percent of the stock or other equity in two or more businesses. For this purpose ownership by an individual is counted only to the extent of the lower degree of ownership in the two businesses being tested.

The scheme to avoid these rules, and the reasons for engaging in the scheme, can be best illustrated by an example.

Assume Smith and Jones are equal partners in the practice of law. If they adopt an H.R. 10 plan, the maximum deductible contribution for each of them under the plan would be \$7,500. If they form a professional corporation, the maximum deductible contribution for each of them will be in excess of \$30,000.⁶

However, in either case, they would also be required to make similar contributions (or provide similar benefits) under the plan for associate lawyers, secretaries and other personnel.

To avoid this result, Smith and Jones separately incorporate their law practices and provide that the Smith professional corporation employs only Smith and the Jones professional corporation employs only Jones. Each professional corporation adopts one or more qualified plans providing the maximum permissible benefits for the only covered employee, respectively Smith and Jones.

Since Smith and Jones still need assistance to practice law they must provide for support personnel notwithstanding their separate professional corporations. Therefore, they form a new partnership, not as individuals but in their corporate capacities—a partnership of corporations. The partnership employs the administrative (secretaries, receptionists) and support (associate lawyers) personnel. Because neither Smith nor Jones has a more than fifty percent interest in the partnership, the partnership is not, under a literal reading of the Code, a member of a group of commonly controlled trades or businesses with either professional corporation. The Tax Court has recently held⁷ that the requirement of aggregation of employees for purposes of meeting the qualified plan rules does not apply here, and that plans established by the Smith and Jones professional corporations need not provide coverage for the partnership employees.

SERVICE OR "LOAN-OUT" CORPORATIONS

Another scheme for excluding rank-and-file employees from the qualified plans of key employees and professionals involves the use of a "service" or "loan out" corporation which is operated by an unrelated party. This approach is intended to insulate the key employee or professional from the rank and file by characterizing the rank and file as employees of the service corporation, not of the key employee or professional corporation. The service corporation scheme is an attempt to reach the same result as the partnership of corporations described above without involving more than one key employee or professional.

Generally, the Internal Revenue Service has taken the position that employment for qualified plan purposes is the same as employment for such public programs as the Federal Insurance Contributions Act ("FICA"). Thus, if an individual is treated as an employee of an employer for FICA purposes, the employee is also treated as an employee of that employer for qualified plan purposes even if the employee performs substantial services for some other person or entity. Thus, where a "loan-out" agency provides service personnel, even on an ongoing basis, the Internal Revenue Service has generally taken the posi-

⁶ It has been argued that elimination of the difference in maximum contributions between H.R. 10 and corporate plans would also eliminate the manipulation of brother-sister entities. However, as noted below, the principal reason for establishing the artificial entity relationships is to limit plan coverage and equalizing the maximum contribution rates would not terminate this opportunity.

⁷ Lloyd M. Garland, M.D., F.A.C.S., P.A., 73 T.C. —, No. 1, (Oct. 4, 1979).

tion that the individuals providing services are employees of the loan-out agency, not of the entity for whom they provide services.⁴

In these cases, the form of the employment agreement is raised over the substance of the working relationship, and the antidiscrimination coverage principles of qualified plans are avoided.

Purposes of plan coverage requirements

Generally, under an income tax system, income is subject to tax when earned, whether it is consumed immediately or put aside for a rainier day. Tax incentives for retirement savings work to defer tax until income is spent, presumably after retirement. This departure from the goal of a progressive income tax system can only be justified as a means of furthering non-tax social policy goals. We believe the goal in the case of retirement plans is the assurance that employees at all levels of compensation will be provided with retirement protection, protection which is particularly difficult to plan and save for at lower income levels. As evidence of this goal, favorable tax treatment is generally allowed only if the plan covers a substantial number of employees of the employer and contributions of benefits provided by employer contributions do not discriminate in favor of officers, shareholders and highly-compensated employees. The Congress gave additional recognition to this policy in providing the controlled group rules described above.

Without these nondiscrimination requirements in plan coverage and in contributions and benefits, the tax system would be ill-equipped to achieve the social goal of providing retirement income to a reasonably broad range of individuals, particularly with respect to those with low or moderate income. The higher a taxpayer's income, the greater the benefits of favorable tax treatment. Such persons are also more likely to save. Low income employees may well opt for current compensation in lieu of retirement protection. The tax benefit alone is insignificant to them and not enough to change their choice. This explains the continuing efforts by some employers to limit their retirement plans to those at high income levels. Despite the fact that the goal of limiting participation is inconsistent with the policy of the nondiscrimination requirements, their effort may succeed in the absence of a requirement that employees providing services to an employer must participate in any tax-favored retirement plan.

This follows both where ownership of related entities is manipulated to avoid aggregation and where individuals are nominally "employed" by a "loan-out" agency but perform services for others on a continuing basis.

H.R. 6140

H.R. 6140 would affect professionals who arrange their business to avoid the statutory definition of a controlled group by requiring the aggregation, for qualified plan purposes, of a professional organization and any "adjunct professional organization" if:

(1) the professional organization regularly uses the services of, or is regularly associated in performing services with, the adjunct professional organization; and

(2) certain minimum ownership tests are satisfied.

For purposes of this provision, an adjunct professional organization is an organization where the employees perform services for persons who perform professional services. For example, the secretaries and other administrative personnel in a law office would constitute an adjunct professional organization if they were employed by an entity separate from the lawyers performing professional services.

H.R. 6140 would eliminate the most common type of abuse in this area. For example, two professionals would no longer be able to avoid covering rank-and-

⁴ Use of this approach was slowed somewhat after the Tax Court decision in *Edward L. Burnetta, O.D., P.A.*, 68 T.C. 387 (1977). In *Burnetta*, services were performed for two professional corporations by individuals whose "records" were maintained, and who were paid, by a service corporation. The Tax Court found that because of the relationship between the professional corporations and the workers, the workers were employees of the professional corporations, not the loan-out corporation. Based on this finding, the plan of one of the professional corporations was held to be nonqualified.

However, notwithstanding the result in *Burnetta*, we understand that a number of practitioners continue to use the service corporation approach but with a more carefully designed relationship among the professional or key employee corporation, the service corporation and the workers.

file employees in a retirement plan by separately incorporating and forming a partnership to hire the rank and file.

We wish to note what we believe is a minor, technical problem with the bill. As noted above, the professional and adjunct organizations are subject to certain minimum ownership tests before aggregation is required. As drafted, one of these tests requires an ownership interest by the professional in the adjunct organization. While the bill also provides for application of the principles in section 267, relating to transactions between related parties, in determining ownership, the attribution rules in section 267 do not require attribution of any non-corporate interest held by a corporation to its shareholders. Thus, to use the example of lawyers Smith and Jones above, the Smith and Jones corporations hold interests in the adjunct partnership and there would be no aggregation under the bill as drafted since neither lawyer individually owns an interest in the partnership and the partnership interests of the professional corporation would not be attributed to the individual lawyers. We hope this problem can be dealt with in drafting a final version of the bill.

Treasury position

We believe H.R. 6140 may not be broad enough to completely eliminate the problem with which it deals. However, we want to emphasize that we agree with the need to remedy the abuses in this area, and we support H.R. 6140 which curtails the most blatant abuse. To the extent the suggestions below will require further study by the Subcommittee which would substantially delay passage of remedial legislation in this area, we support the immediate passage of H.R. 6140 with an understanding that we will continue to work with the Congress to fashion broad remedies to the remaining forms of abuse.

The two areas where we wish to discuss a broader approach relate to: (1) the scope of affected employers, and (2) the treatment of individuals performing services under an arrangement with a "loan-out" company.

SCOPE OF AFFECTED EMPLOYERS

H.R. 6140 limits its aggregation rules to those situations where professional services are provided. For this purpose, professional services include services performed by physicians, dentists, chiropractors, osteopaths, optometrists, other licensed practitioners of the healing arts, attorneys at law, public accountants, public engineers, architects, draftsmen, actuaries, psychologists, social or physical scientists, and performing artists.

While we agree that current case law² indicates that the controlled group abuse is most prevalent in the professions, other individuals who do not perform professional services will also undoubtedly take advantage of these cases. We believe the abuse should be curtailed generally, and therefore recommend revision of the bill to allow aggregation of related organizations in any appropriate circumstance, not solely where one of the organizations is providing professional services.

"LOAN-OUT" CORPORATIONS

H.R. 6140 does not address the abuse arising in the "loan-out" area, and we wish to open a dialogue with the Subcommittee to consider legislative provisions to cover this problem.

As noted above, the Internal Revenue Service has generally held that an individual's status as an employee for employment tax purposes (e.g., for Federal Insurance Contribution Act (FICA) taxes) is determinative of the individual's status for qualified plan purposes. Thus, if an individual is considered an employee of a service or "loan-out" corporation for FICA purposes, he or she is considered an employee of the corporation for plan purposes and is not considered an employee of the corporation where the individual is "temporarily" assigned. Historically, the Internal Revenue Service has not recognized that an individual may be an employee of two employers with respect to the same services for qualified plan purposes.

This approach makes sense from the viewpoint of payroll tax administration since it is crucial to the Service's revenue collecting role that there be a readily identifiable source for the collection and payment of employment taxes. Where an individual performs temporary services for many organizations, it is also

² See, e.g., *Lloyd M. Garland, M.D., F.A.C.S., F.A.*, 73 T.C. —, No. 1 (1979); *Thomas Kiddie, M.D., Inc.*, 69 T.C. 1055 (1978).

helpful to have a single source for the collection (and reporting) of employment taxes.

However, we do not believe it is necessary to ignore the potential of dual employment in the qualified plan area in order to achieve certainty in the area of employment tax collection. It seems that in many cases involving "temporary" help or services, the individuals involved are in an employee-employer relationship with the organization which has contracted with the service corporation or "loan-out" agency. For example, if an agency provides secretarial help to a business office, it is likely that the business office will actually exercise control over the performance of the secretary's services and will generally establish, among other things, the manner in which the work is to be performed. This is particularly true when the "temporary" worker stays in the same job for an extended period. In such a case, we do not believe the substance of the relationship between the individual and the office is accurately reflected by adherence to a mechanical rule which holds that an individual's status for employment tax purposes is determinative. We believe that it would be appropriate to treat the individual in this case as an employee of the office for qualified plan purposes.

We have begun a review with the Internal Revenue Service of the issues involved in the Service's historical approach to determining whether an individual is an employee for qualified plan purposes. We believe the historical approach may be changed administratively, and we are considering the available options in this regard. However, we recognize that there are limitations inherent in proceeding on such a course through regulations or other rule making and we appreciate this opportunity to open a dialogue with the Congress which will hopefully lead to a satisfactory solution to this problem area.

One possible approach would be to require that employers count the hours of service of "temporary" service employees in determining eligibility, etc., under the employer's plan. Section 410 allows the exclusion from a plan of any employee who has not completed a year of service, and a year of service is generally defined as completing 1,000 hours of service in a 12-month period. Assuming the plan uses a 10-hour-per-day "equivalency" method for crediting hours of service, the "temporary" employee would need to perform services for the employer for 100 days before any question of plan eligibility arose. Since there are only about 250 working days in a year, it does not seem that such an approach would work an undue burden on plans.

We would appreciate the opportunity to pursue this matter and other options which may be available with the Subcommittee and staff. However, as noted above, we do not want to delay the passage of H.R. 6140 solely to give additional consideration to this issue.

H.R. 6247—MARRIED INDIVIDUALS LIVING APART BUT SUBJECT TO COMMUNITY PROPERTY LAWS

Under community property law, income received by a spouse during the marriage (other than income from a class of property characterized as separate property) legally belongs one-half to each spouse. Certain Federal income tax consequences flow from this fact. For example, spouses who file separate returns in a community property state are each required to include on that return one-half the community income. In common law jurisdictions, if spouses file separately, each reports only the income attributable to his or her own efforts, or from property owned by the spouse.

In a community property state, a spouse who has been abandoned must report and pay tax on one-half the community income. The income must be reported even if the abandoned spouse has no way of knowing of the existence, or amount of the income, and has little or no practical way of paying tax. This result could not occur in a common law state. In such a state, an abandoned spouse would be required only to file a return and pay taxes on income actually earned (or from property actually owned) by the spouse. Moreover, the present innocent spouse provisions offer no relief to the abandoned spouse in the community property state because that provision applies only when a joint return is filed. As a result, there have been cases in which a wife was held liable for the tax on income earned by the husband even though she had received no benefit from the income and had only modest assets of her own.

Under H.R. 6247, if spouses are living apart for the entire year, and no earned community income is transferred between the spouses, community property income will be taxed in accordance with common law principles. Thus, this bill will

remedy some of the problems of spouses in community property states. But we think that the relief can and should be broader.

First, the bill does not clearly grant relief for all community income. An abandoned spouse has no greater access to or information about passive investment income than he or she may have about earned income or income from a trade or business. We recommend expansion of this provision to include all community income.

Second, no relief is available if the abandoned spouse has received as little as one dollar of the other spouse's earned income. We recommend that the bill be amended to provide that if any property is transferred between the spouses, that the recipient spouse be taxed on that amount, with a corresponding exclusion from income for the other spouse. The bill should also provide that all property received by a spouse will be deemed to be income. In the absence of such a rule the abandoned spouse could argue that the property transferred was in the nature of a property settlement and was therefore not taxable as income.

Third, the bill only offers relief when both spouses have earned income which is community income. We see no reason for this requirement. Even if the abandoned spouse has no earned income, he or she should be entitled to relief.

If the bill is expanded to provide relief as outlined above, certain technical modifications would be required. To eliminate the potential for abuse, and collusion between spouses for the purpose of effecting advantageous income splitting (something not available to common law spouses, who if they file separately are liable for tax only on the income attributable to each), relief should only be available if justified by the facts and circumstances. Additionally, if relief is given for all community income, the bill must be modified to insure that all income is properly attributed (generally by analogy to common law principles).

Even if these changes in the scope of H.R. 6247 are not made, there are two problems with H.R. 6247 that should be remedied. As presently drafted, the bill is mandatory. Thus, if the conditions are satisfied, income must be divided in accordance with essentially common law rules. Community property spouses who live apart must report their income as prescribed in the bill. There may well be circumstances in which a husband and wife are separated but still wish to file separate returns, each reporting one-half the community income. They are permitted to do so under present law. They should continue to have this option.

Also, the bill should clearly state that when the abandoned spouse is relieved of liability for tax on any income other than that which has been received, the balance of the income is to be reported by the other spouse.

We would like to point out that other similar problems are not addressed in the bill. The bill does not apply in the year the spouses separate. Nor does it apply where a husband or wife are living together, and one spouse deprives the other of his or her share of community income, even if the deprived spouse may be completely unaware of the income and receive no benefit from it. We are studying these problems. However, they are very difficult and we are not confident they can be solved. In the interim, we support H.R. 6247 and recommend that the changes outlined above be adopted.

H.R. 6824—TREATMENT OF NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS OF TAX-EXEMPT EMPLOYERS

H.R. 6824 would provide that the year of income inclusion for amounts subject to a nonqualified deferred compensation arrangement maintained by a tax-exempt employer would be determined under the principles applicable to deferred compensation arrangements in effect on February 1, 1978. This would allow employees of tax-exempt employers to individually elect to defer any amount of compensation without regard to the rules relating to qualified retirement plans. The Treasury Department is strongly opposed to H.R. 6824.

On February 3, 1978, the Internal Revenue Service published proposed regulations which would have applied the doctrine of constructive receipt to all arrangements where employees have an individual option to defer the payment of compensation. In many cases, these arrangements were provided in lieu of a qualified, funded retirement plan. Because the deferral option could be provided selectively to highly-compensated employees and the benefits of deferral were then subject to the employee's election, the availability of such arrangements decreased the likelihood that an employer would establish a funded, qualified retirement plan covering all classes of employees.

The Revenue Act of 1978 prevented the application of the rules in the proposed regulations to employees of a taxable entity. Taxable entities were exempted from the proposed rules because an employer's deduction for compensation is postponed until the deferred amount is included in the employee's income. This deduction deferral will, in many cases, make a nonqualified plan of deferred compensation less attractive than a qualified plan. However, this result does not follow in the case of a tax-exempt employer where there is no deduction for the payment of wages.

Accordingly, the 1978 Revenue Act provision exempting taxable entities from the proposed regulations did not extend the same treatment to tax-exempt organizations. We believe this distinction is justified and we oppose the effort in H.R. 6824 to extend the treatment of taxable employers to tax-exempt employers.

Looking solely at the issue of incentives to establish a qualified retirement plan, the tax-exempt employer gains no benefit from the deductibility of wages and is generally exempt from tax on its own income, so that the cost to the tax-exempt employer of a qualified plan is no less than the cost of providing the same benefit to an individual employee under a nonqualified plan.³⁰ Thus, there is little, if any, tax encouragement at the employer level for a tax-exempt organization to adopt a qualified plan.

Perhaps more disturbing, under Title I of ERISA if a nonfunded plan is maintained, it may only provide benefits primarily for a select group of management and highly-compensated employees. Therefore, if a tax-exempt employer is in a tax-neutral position between qualified and nonqualified plans, this will, in effect, encourage and in some cases require the discriminatory provision of retirement benefits.

We would also like to answer one other argument which has been raised in this area. It is often stated that the deduction for wages available to a taxable employer reduces the cost to the employer to 54 cents on the dollar. However, this is only true if the corporation pays compensation out of what would otherwise be after-tax profits. A corporation entering a particular activity must expect to earn enough to cover its costs (including salaries) plus an adequate return on its investment, after taxes. Thus, if the net return is to remain constant, an additional one dollar of gross revenue must be received for each additional one dollar of compensation payable if the payment is deductible; if not deductible, the additional revenue must be sufficient to cover both the tax on the income and the amount of the nondeductible payment.³¹ Therefore, the "54 cent dollar" argument is not persuasive.

There are two other ways to deal with the treatment of nonqualified arrangements provided by tax-exempt employers: through regulations or a different legislative approach. In the regulatory area, the Internal Revenue Service published a news release in June of last year seeking further comments on the February 3, 1978 proposed regulations as they would relate to employees of tax-exempt organizations. A public hearing was held at the Internal Revenue Service on November 27, 1979.

Comments were submitted in writing and at the hearing regarding the standards to be used and the evidentiary problems which may arise in determining the existence of a deferral option for employees of tax-exempt employers. We have given considerable thought to these comments.

³⁰ Under one set of assumptions, the annual after-tax cost to a taxable employer to provide a \$100 annuity for one employee changes from \$183 to \$114 if a qualified plan is used rather than a self-funded investment pool. This is a reduction of 38 percent and tends to encourage the use of qualified plans by taxable employers. However, the cost to the tax-exempt employer of funding one employee's benefit is the same under either a qualified or a nonqualified plan.

³¹ For example, assume Corporation X buys widgets for \$100 and wants a 10 percent after tax return on its investment. X must sell the widgets at a price sufficient to provide a return of \$10 after costs and taxes. If the only cost involved is a \$5 commission to the widget salesperson, and if X is entitled to deduct that payment in computing its taxes, then the price charged for the widgets will reflect only the \$5 cost. However, if the \$5 of compensation is not deductible, then, if the return is to remain at \$10, X must raise the price of the widgets to cover both the compensation payment and the tax due on that payment. Of course, the status of the compensation payment as a deductible or nondeductible item would not matter if X could claim tax-exempt status since in that case no additional amount would be needed to pay any taxes. A detailed explanation of this analysis is attached as appendix A.

We recognize that proceeding on a course of rulemaking by regulation has its limitations. Therefore, we are also considering a legislative proposal, S. 511, introduced by Senator Matsunaga on March 1, 1979, which would apply the same limitations on nonqualified deferred compensation for tax-exempt organizations as are currently provided for the nonqualified arrangements of State and local governments. We believe the status of tax-exempt employers is more appropriately analogized to State and local governments than to taxable employers since State and local governments are also tax exempt. Certainly there is no reason to favor high-income employees of tax-exempt organizations over rank-and-file employees of State and local governments.

The limitations on the use of nonqualified deferred compensation arrangements for individuals furnishing services to State and local governments were added by the Revenue Act of 1978 as section 457 of the Internal Revenue Code. These rules limit the percentage of compensation which may be deferred as well as the absolute dollar amount of the deferrals. Although these limitations clearly mitigate the disproportionate benefit under such arrangements previously available to highly compensated individuals, neither section 457 nor S. 511 would provide specific antidiscrimination rules for these plans. This is in contrast to the nondiscrimination tests provided in the 1978 Revenue Act for other salary reduction deferred compensation arrangements.

On the other hand, because section 457 places limits on the total amount which may be deferred, whether or not an employee exercises an individual option, evidentiary problems in establishing whether or not a deferral option exists would be avoided under this approach.

We continue to believe that section 457 would be improved by incorporation of nondiscrimination requirements, but we are also interested in continuing to explore the possibility of a legislative solution to this problem along the lines of S. 511. While we are proceeding with preparation of a final regulation relating to deferred compensation arrangements for employees of tax-exempt organizations, we will not publish such a regulation until we have had a further opportunity to pursue possible legislative solutions with this Subcommittee and other interested members of the Congress.

I will be glad to answer any questions you may have.

APPENDIX A

EXPLANATION OF EFFECT OF DEDUCTION FOR COMPENSATION

[Corporation X buys widgets for \$100 and wants a return of \$10 after tax. Assuming a 50-percent tax rate and that \$5 of compensation to the widget salesperson is the only expense involved, the price of the widgets where the compensation is deductible or nondeductible (and where X is tax exempt) will be as follows:]

	Taxable		Tax-exempt
	Compensation deductible	Compensation not deductible	
Sales price.....			
Costs and expenses.....	\$125 105	\$130 105	\$115 105
Before tax income.....	20	25	10
Taxable income.....	20	30	
Tax at 50 percent.....	10	15	
Return.....	10	10	10

Mr. GUTMAN. Thank you, Mr. Chairman.

In the interest of time I will ask that our statements be put in the record.

Mr. ROSTENKOWSKI. Your entire statements will be put in the record.

Mr. GUTMAN. The Installment Sales Revision Act of 1980, which you and Mr. Duncan are cosponsoring, is the first major substantive tax simplification effort of this Congress. At the hearings on this bill's predecessor, H.R. 3899, Treasury reaffirmed the high priority we place upon simplification as a tax policy goal. We also agreed that the

installment sales area was an excellent place to begin what we hoped would be an ongoing simplification process.

The history of the installment sales bill indicates this process is off to a promising start. Since the completion of the July hearings on H.R. 3899, Treasury, along with those groups whose representatives were willing to devote the requisite time and effort to engage in constructive dialog, have been intimately involved with the staff in the development of the revised installment sales bill.

This process of attacking a discrete area of the tax law has been both instructive and rewarding. The prevailing attitude of those who chose to participate in the process was one of concern for the dual goals of simplification and maintenance of the integrity of a tax based on income. In particular, the participants shed parochial interests in order to attain these objectives. The result is H.R. 6883, a bill which Treasury firmly endorses.

Now, I don't want to spend time going through all of the technical aspects of the bill, but because it is a more ambitious bill than its predecessor, I would like to mention briefly some of the major areas in which it differs from H.R. 3899.

One of the major changes made by H.R. 6883 is the creation of a general rule for the reporting of all income from deferred payment sales. Under the bill unless the seller otherwise elects, income generally is recognized as deferred payments received. Thus the bill reflects the decision that, in general, deferred reporting of gain is appropriate when payment is deferred. This general rule accomplishes a number of significant and welcome results.

First, it will eliminate the election requirement of present law and thereby remove the trap for taxpayers who, for the most part, desire to defer reporting.

Second, it greatly expands the availability of the deferred reporting privilege to include in particular sales in which the seller receives more than 30 percent of the selling price in the year of sale, and sales in which the total price is uncertain or subject to a contingency. In both these cases the seller would not be entitled to statutory deferred payment reporting under present law.

Third, the uncertainty which surrounds the calculation of the present law 30-percent limitation is eliminated. That 30-percent limitation has proved a fertile ground both for error and litigation.

Fourth, and in our view very important, the inducement to structure normal business transactions in a byzantine manner in order to achieve deferred reporting of gains is removed. In this regard alone the bill makes a substantial improvement.

It is also true that mandatory deferred gain recognition could work hardships in some situations. Therefore, the bill allows taxpayers to elect out of installment sale reporting. When a taxpayer elects out of the installment method the gain in the year of sale will be equal to the difference between the value of deferred obligations and the seller's basis.

Now, this is different from the rule which Treasury had previously proposed. Earlier we had suggested that ratable basis recovery apply, as is the rule with regard to payments which are on the deferred method, to transactions which were not reported on the installment method.

Our purpose in suggesting this rule was to provide consistent basis recovery rules whether one was in or out of the deferred recognition system and to eliminate the incentive to engage in tax "planning," to use a euphemism, such as that described in a recent article in the *Journal of Taxation*, where people are advised to engage in a number of techniques which it is hoped will give the result of cost recovery prior to the recognition of any gain.

However, for purposes of this bill we have accepted the representations of professional groups that the proposal we previously made will cause difficulty in those rare cases involving unascertainable sales prices and, in addition, that allowing a form of cost recovery to apply would not invite taxpayers to engage in aggressive structuring of transactions to achieve full basis recovery prior to gain recognition.

The existence of the election out mechanism will enable us to monitor the circumstances under which taxpayers choose to accelerate gain or attempt to use this option artificially to structure transactions. If our scrutiny reveals any significant efforts by taxpayers to recreate the morass of options which are presently available, we shall ask Congress to reconsider the tax consequences of an election out.

Another major aspect of the bill which I would like to touch on briefly deals with sales between related parties. The installment method, as you recall from the prior hearings, currently is being abused by taxpayers who sell appreciated property to related persons and then the related person immediately resells the property to a third party, many times as a part of a prearranged transaction. The result of this is that the original seller gets to defer recognition of gain and the related person receives the full sale proceeds tax free because that person's basis is equal to the purchase price of the property from the seller. Thus, the economic unit which is comprised of the two related persons has cash equal to the value of the property while the tax on the gain is deferred.

Virtually every witness appearing before the subcommittee at its hearings on the prior bill recognized that this particular technique constituted an abuse. However, all agree that the prior bill's way of dealing with the abuse was too broad in its impact, particularly where the subject of the installment sale was a farm or closely held business. Testimony in July on related party sales focused on the source of the abuse—the disposition of the property by the related party buyer—and this is the approach which the present bill takes. A subsequent disposition of the property by the related person within 2 years of the original sale will result in acceleration of gain to the original seller. Thus, the bill provides a bright line test which is designed to separate prearranged transactions from those which occur in the normal course of business.

The bill also recognizes that even this narrowly focused formulation may result in some unwarranted acceleration of gain recognition. Thus, it provides a number of specific exemptions and a blanket rule by which taxpayers can escape the consequences of gain recognition to the first seller.

The result is a rule that Treasury believes to be fair. The parent who sells the family farm or the closely held business interest to a child in a transaction which is structured to allow the child to pay for the interest over time, is not going to be affected by this rule so long as the

child does not sell the acquired interest within 2 years. Thus the rule will not cause problems for family farms or those businesses which are intended to be kept in the family.

Moreover, even if the related purchaser does sell some property within 2 years, gain will not be accelerated, if one of the specific exemptions applies or tax avoidance was not the purpose.

In other words, ample flexibility exists to deal with difficult cases as they arise.

I have one comment on the effective date of the related party rule. The related party rule in the bill is to apply to installment sales occurring after March 31, 1980. This date we believe gave sufficient notice to taxpayers so that they should have been aware of its existence, and we believe that arguments to postpone this effective date should be viewed with a healthy skepticism. The reason for this is that any sale occurring after March 31, 1980, will not be subject to the new rule unless income tax avoidance was the principal purpose of the transaction. Those who argue for a postponement of the effective date are in substance asking the Congress to prolong explicitly the opportunity to avoid tax.

I have highlighted certain portions of the bill. The bill also remedies an anomaly in section 337 liquidations—in fact the very anomaly which led to the original related party abuse. The bill also clarifies and rationalizes the application of the installment rule to like exchanges, refines the definition of disposition of installment obligations, and applies to executors and heirs the rules presently available for sellers who reacquire in foreclosure property sold for future payment.

Mr. Chairman, we all advocate technical tax simplification. We all also recognize that dramatic improvements cannot be achieved overnight. But unless some results are assured we cannot expect the professional tax community or the staffs to expend the resources necessary to engage in this project.

H.R. 6883 in this context is the barometer of the future of tax simplification. We are grateful for the leadership you have taken in this simplification effort and we appreciate the fact that you and Mr. Duncan have cosponsored this bill. We now urge expeditious favorable subcommittee action on it.

[The prepared statement follows:]

STATEMENT OF HARRY L. GUTMAN, DEPUTY TAX LEGISLATIVE COUNSEL,
DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to appear today to present the views of the Treasury Department on H.R. 6883, the Installment Sales Revision Act of 1980.

INTRODUCTION

The Installment Sales Revision Act of 1980 is the first major substantive tax simplification effort of this Congress. At hearings on this bill's predecessor, H.R. 3899, Treasury reaffirmed the high priority it places upon simplification as a tax policy goal. Moreover, we also agreed that the installment sale area was an excellent choice for beginning what we hope will become an ongoing simplification process.

The history of the installment sale bill to date indicates that the tax simplification process is off to a promising start. At the hearings on H.R. 3899, Treasury urged this Subcommittee to go beyond the specific provisions of that bill and address the area of sales for deferred payment more generally. We submitted a

number of specific proposals for simplification. Representatives of the Section of Taxation of the American Bar Association, the Tax Committee of the American Institute of Certified Public Accountants and the Tax Committees of the New York State and City Bar Associations testified in support of both the concept and the general framework of the Treasury proposals.

At the completion of the July hearings, Mr. Chairman, you directed the Staff of the Joint Committee on Taxation to meet with Treasury and the various groups who had indicated an interest in this area. The objective was to produce a revised bill incorporating the proposals made and resolving adequately the issues raised in the testimony and comments received by the Subcommittee. Treasury, along with those groups whose representatives were willing to donate the requisite time and effort to engage in constructive dialogue were, thereafter, intimately involved with the staff in the development of the revised installment sale bill.

This consensual process of attacking a discrete area of the tax law has been both instructive and rewarding. The prevailing attitude of those who chose to participate in this process was one of concern for the dual goals of simplification and maintenance of the integrity of a tax based on income. These participants shed parochial interests in order to attain these objectives. The result is H.R. 6883, a bill which Treasury endorses.

H.R. 6883

I do not intend to examine all the technical aspects of H.R. 6883. However, because H.R. 6883 is a more ambitious bill than its predecessor, I should like to mention the major areas in which it differs from H.R. 3899 and also, where appropriate, to highlight the resolution of problems identified in prior testimony.

GENERAL RULE

H.R. 6883 creates a general rule for the reporting of income from deferred payment sales. Under the bill, unless the seller otherwise elects, income generally is recognized as deferred payments are received. Thus, the bill reflects the decision that, in general, deferred reporting of gain is appropriate when payment is deferred. The bill does not, however, alter existing law as to what constitutes payment in any particular year (except as specifically provided in connection with like-kind exchanges described in 1031(b)).

The general rule accomplishes a number of significant and welcome results. First, it eliminates the election requirement of present law and thereby removes a "trap" for taxpayers who, for the most part, desire the deferred reporting privilege. Second, it greatly expands the availability of the deferred reporting privilege to include, in particular, sales in which the seller receives more than thirty percent of the selling price in the year of sale and sales in which the total price is uncertain or subject to a contingency. Third, uncertainty surrounding the calculation of the present law thirty percent threshold limitation, which has proved a fertile ground for error and litigation, is eliminated. Fourth, the inducement to structure normal business transactions in a byzantine manner in order to achieve deferred reporting of gain is removed.

The key to allowing deferred payment reporting where the gross profit or total contract price (or both) is uncertain or subject to contingencies lies in the development of rules requiring basis to be allocated ratably to the deferred payments. This is recognized in the bill. However, rather than attempting to provide basis allocation rules for every conceivable transaction, the bill provides that specific rules will be prescribed by regulation. Thus, unusual cases can be resolved as they arise.

In general, the regulations to be promulgated pursuant to this authority will provide that, for sales under which there is a stated maximum selling price, basis will be recovered in accordance with a gross profit ratio determined by reference to the stated maximum selling price. In general, where the sales price is indefinite but payable over a fixed period of time, the basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, the regulations will permit ratable basis recovery over some reasonable period of time, such as 20 years. Also, in appropriate cases, basis recovery will be permitted under an income forecast type method.

ELECTION TO ACCELERATE RECOGNITION

Mandatory deferred gain recognition could work hardships where taxpayers desire to accelerate recognition, for example, to use otherwise expiring carryovers. Some witnesses also expressed concern that in the rare case where it was not possible to calculate the value of the consideration to be received by the seller, it would likewise be impossible to provide an adequate ratable basis recovery rule.

These concerns are addressed by permitting taxpayers to elect not to report gain on the installment method. To avoid taxpayer attempts to whipsaw the Internal Revenue Service, an election out of the installment method must generally be made on or before the due date (including extensions) of the taxpayer's return for the year of the sale. An election may be revoked with the consent of the Secretary. That consent will be granted where a tax avoidance purpose is not present.

Where a taxpayer elects out of the installment method, the gain the year of sale will be equal to the difference between the value of the deferred payment obligation and the seller's basis. This rule is different from that recommended by Treasury in previous testimony. Earlier we had suggested that ratable basis recovery apply also to transactions which were not reported on the installment method. The amount realized in the year of sale would be reduced by an allocable portion of basis and the balance of the basis would be recovered against future payments. Treasury's purpose in suggesting this rule was to provide consistent ratable basis recovery rules and to eliminate the incentive to engage in tax "planning", such as that described at page 203 of the April, 1980 issue of the Journal of Taxation, to achieve basis recovery prior to gain recognition. For purposes of this bill, however, we have accepted the representations of the professional groups that the proposal we previously made would cause difficulty in those rare cases involving unascertainable sales prices and that allowing a cost recovery approach to apply would not invite aggressive structuring of transactions to achieve full basis recovery prior to gain recognition.

The existence of the election out mechanism will enable Treasury and the Internal Revenue Service to monitor the circumstances under which taxpayers choose to accelerate gain recognition or attempt to use this option artificially to structure transactions to obtain basis recovery prior to recognition of gain. If this scrutiny reveals any significant efforts by taxpayer to recreate the morass of options available under present law with regard to basis recovery, we shall ask the Congress to reconsider the tax consequences of an election out.

SALES TO RELATED PARTIES

The installment method is currently abused by taxpayers who sell appreciated property to related persons (for example, a trust set up for the benefit of the seller's children), who immediately resell the property to a third party as a part of a prearranged transaction. The original seller defers recognition of gain. The related person receives the full sale proceeds tax free because the tax basis of the property in the hands of the related person is its purchase price. Thus, the economic unit comprised of the two related persons has cash equal to the value of the property while deferring taxation of the gain which would have been immediately recognized had the initial sale been for cash.

Every responsible witness appearing before the Subcommittee at its hearings on H.R. 3899 recognized that this technique (known as the *Rushing* rule, after the case which upheld the tax treatment described above) constituted an abuse which should be eliminated. However, all also agreed that the H.R. 3899 flat prohibition of installment reporting for sales between certain related parties was too broad in its impact, particularly where the subject of the installment sale was a farm or closely held business interest.

Testimony in July suggested that a related party sale rule should focus on the source of the abuse—the disposition of the property by the related party buyer and this is the approach taken by H.R. 6883. Due to the attention this provision has attracted, and in anticipation of further comment by those who appear to believe that tax simplification cannot, by definition, address acknowledged abuses, it is appropriate to describe the related party rule of H.R. 6883 in some detail.

Under the bill, sales to family members, controlled corporations and partnerships, or to trusts and estates in which any related person has a specified inter-

est will be subject to a special disposition rule. For purposes of this rule, persons will be treated as related if stock ownership in any amount would be attributed from one to the other under section 318(a). A subsequent disposition by the related purchaser will result in the acceleration of gain recognition on the installment obligations held by the seller equal in amount to the consideration received in the second sale.

This rule would not apply to dispositions of the property (other than marketable securities) by the related purchaser more than two years after the first sale. Thus, the bill provides a bright line test designed to separate pre-arranged transactions from those which occur in the normal course of business. The running of the two-year period would be suspended, however, if the related purchaser substantially diminishes his risk of loss through a short sale, the holding of a "put" or similar transaction.

The bill recognizes that even the above narrowly focussed formulation may result in unwarranted acceleration of gain recognition to related sellers where dispositions by related purchasers are occasioned by unforeseen events, economic necessity or do not result in the abuse the section is intended to cure. Thus, dispositions after the death of either the purchaser or seller, dispositions which occur by reason of an involuntary conversion where the initial sale occurred prior to the threat of imminence of the conversion, and sales by the issuing corporation of stock acquired from a related person are specifically excepted from the related party rules. In addition, if it can be established to the satisfaction of the Secretary that neither the first nor the second disposition has as one its principal purposes the avoidance of Federal income tax, the disposition may be exempted from this rule. Treasury will issue rulings and regulations describing categories of transactions which qualify for the latter exception, but it will not be necessary for taxpayers to obtain advance rulings in order to qualify.

The result is a rule Treasury believes to be fair. The parent who sells the family farm or closely held business interest to a child in a transaction structured to allow the child to pay for the interest over time is not affected by this rule so long as the child does not sell the acquired interest within two years. Thus, the rule will not cause problems for farms or businesses kept in the family. Moreover, even if the related purchaser does sell within two years, gain will not be accelerated if one of the specific exemptions applies or tax avoidance was not a principal purpose of the transaction. Thus, ample flexibility exists to deal with difficult cases as they arise.

The related party rule will apply to installment sales occurring after March 31, 1980. This date gave sufficient notice after H.R. 6883 was introduced so that taxpayers should have been aware of its existence. Moreover, arguments to postpone the effective date should be viewed skeptically in light of the fact that any sales occurring after March 31, 1980, will not be subject to this rule unless income tax avoidance was a principal purpose of the transaction.

SECTION 337 LIQUIDATIONS

Under current law, a corporation generally recognizes no gain upon the distribution of installment obligations to its shareholders pursuant to a twelve-month liquidation under section 337, except for recapture and other similar items. However, shareholders are taxed upon receipt as having received a distribution equal to the fair market value of the notes.

This structure leads to disparate results at the shareholder level depending upon whether a corporation sells its assets for installment obligations and then liquidates under section 337 or the shareholder sells stock in the corporation for installment obligations. In one case, gain attributable to the unpaid installment obligation is accelerated; in the other, it is not.

The transaction in which Mr. Rushing engaged was designed to avoid precisely this anomaly. The bill recognizes the anomaly and eliminates the need for future *Rushing* type transactions in this area by providing that, in general, installment obligations received by corporations for assets sold after the date of adoption of a section 337 plan may be distributed to shareholders as liquidating distributions without gain acceleration.

SUMMARY

I have highlighted certain portions of H.R. 6883 for the Subcommittee's attention. I hasten to add that the bill clarifies and rationalizes the applica-

tion of the installment sale rules to like-kind exchanges, refines the definition of the disposition of an installment obligation and applies to executors and heirs the rules presently available for sellers who reacquire, in foreclosure, property sold for future payment.

It should be apparent from the foregoing that H.R. 6883 is an ambitious undertaking. Admittedly it does not address every problem in the area of sales for future payment. Issues such as the rationalization of the treatment of "collection gain" and a uniform definition of what constitutes "payment" are important and deserve continued study. However, time is needed for Congressional and Treasury staffs and for tax practitioners to analyze these additional areas.

In the meantime, it is important that the simplification process show some tangible results. We all advocate technical tax simplification. We also recognize that dramatic improvements cannot be achieved overnight. But unless results are assured, we cannot expect the professional tax community or the staffs to expend the necessary resources.

Mr. Chairman, we are grateful for the leadership you have taken in this effort. H.R. 6883 represents the consensus of many diligent and objective participants and we appreciate the fact that you and Mr. Duncan have co-sponsored the bill. We now urge expeditious favorable Subcommittee action on it.

Mr. ROSTENKOWSKI. Thank you, Mr. Gutman.

Mr. Gutman, after hearing your remarks on the installment sales legislation and reviewing some of the prepared statements of those that will follow you, I sense we have finally come to a consensus on a series of improvements in a long, troublesome area of the Code. I am wondering why, Hank, you weren't as successful and as persuasive in forming a similar consensus on a little matter of carryover basis?

Mr. GUTMAN. The equities were even more clear there, sir.

Mr. ROSTENKOWSKI. Seriously, I want to commend both you and Don Ricketts of our Joint Committee staff and all others who have worked many months laboriously on this very technical and important package. It shows that every once in a while we can really improve the status quo.

Mr. GUTMAN. Thank you.

Mr. ROSTENKOWSKI. Mr. Halperin, I am somewhat surprised by the statement in your testimony on H.R. 5616 that there was not an unintended result of the trade bill. This is not what others have said to me. Would you please elaborate a little bit on the point?

I think this is critical in the consideration of this issue.

Mr. HALPERIN. Yes, Mr. Chairman. Obviously I was not a party to the proceedings but the suggestion that this was an unintended result was raised in the Finance Committee when this was brought up at a markup session, and it was raised in connection with other testimony that has been given on this bill.

I have been assured by the people in the Treasury responsible for this area that that is not the case, that the result was intended, and it was a necessary element of the attempt to equate the treatment of imported and domestically produced liquors.

They also point out the statement in the Ways and Means Committee report which is cited on page 4 of my testimony. It is clear from that statement that at least the people who wrote the committee report intended the result.

I cannot respond to the specified examples that Congressman Coelho gave of people giving assurances. I will, however, ask our people to respond to those statements at a markup session or in any way you would like.

Mr. ROSTENKOWSKI. On the related issue of the treatment of flavoring materials, am I correct that if this subcommittee against the judg-

ment of Treasury, decides to move ahead on the Coelho bill, it would be appropriate to address the flavoring issue as well?

Mr. HALPERIN. As we indicated in the testimony, it would be hard to distinguish between the two cases. Certainly if one group is going to get favorable treatment, the other one could make the same argument.

We are opposed to both changes, however. I think it is our general feeling that if there is going to be a result that we consider unfortunate, that should not be used as an argument for extending it to another group. If we carry that argument too far we are multiplying the numbers of inequities and loopholes in the tax law. So we are opposed to both changes, and if you make one change we will continue to oppose any further changes along those lines, although we have indicated that it may be a very hard argument to make to separate one group as opposed to the other.

Mr. ROSTENKOWSKI. Can you think of any other liquid industry that would feel they are being unjustly treated as a result of this legislation and they would then suggest we give them the same consideration?

Mr. HALPERIN. No, I cannot.

Mr. ROSTENKOWSKI. Finally, this bill, Mr. Halperin, also addresses taxation of similar products that are imported. Does this return these products to the pretrade bill status or is this a new tax cut for imported distilled spirits made from wine?

Mr. HALPERIN. It is the latter. It does not return them to their pretrade bill status but does give them a tax cut. One of the purposes of the trade bill was to get consistency between imported and domestic liquor products. The trade bill accomplished that in part by raising the tax on the domestically produced liquors. What this proposal does is return the domestic to the prior system and lower the tax burden of the imported ones.

We have indicated in our testimony that we are going to find it impossible to police that. If somebody comes in with an imported liquor, the tax would be \$10.50 per proof gallon if the alcoholic content is from spirits, and the tax would be considerably lower, around \$3 to \$5 per proof gallon, if it is wine. We are told that the laboratory cannot tell whether the source of the alcohol content is wine or spirits, and cannot tell the alcoholic content of the particular wine that may have been used.

We feel it is not possible to enforce these provisions with respect to imported liquor, and therefore if one is going to maintain consistency, the provisions in the law as it now stands are essential.

Mr. ROSTENKOWSKI. We would have to be concerned whether or not this is factored into the revenue estimates of this committee, is that right?

Mr. HALPERIN. They apparently do not really know how much, if any, of the revenue loss would be attributable to imported liquors or what the amount of that would be.

Mr. ROSTENKOWSKI. Mr. Duncan?

Mr. DUNCAN. Thank you, Mr. Chairman.

In relation to H.R. 5729, Mr. Halperin, what is your definition of a startup cost and how is this different from realty expenses or organizational and syndication expenses?

Mr. Halperin, or Mr. Gutman, either one of you can answer that.

Mr. GUTMAN. I will give it a try. The startup costs which are covered by this bill would be costs which are incurred in investigating a business.

Mr. DUNCAN. Incidentally, may I state Mr. Schulze had to leave, that these are questions of his, and we could give them to you in writing. There are several questions if you would like to have them.

Mr. GUTMAN. If you would prefer to do that, that is fine.

Mr. ROSTENKOWSKI. Without objection, then, that will be done.

[The questions are as follows:]

CONGRESSMAN SCHULZE'S QUESTIONS FOR TREASURY WITNESS CONCERNING H.R. 5729

1. This bill deals with the amortization of startup costs by a business "functioning as a going concern."

Question A. First, what is your definition of startup cost and how is this different from "pre-opening expenses" or "organizational fees" and syndication expenses?"

Question B. Expenses are often incurred even before the partnership agreement or corporate papers are filed or any liabilities are undertaken. When does a partnership, corporation or individual begin to incur "startup costs" for purposes of the bill?

Question C. What does "functioning as a going concern" mean? Does it mean that operating expenses for advertising, insurance, utilities and so on are not deductible until a revenue stream commences?

Question D. Based on your definition of going concern, let's take a hypothetical example of a taxpayer in business to construct and operate a commercial office building. Would the taxpayer be "functioning as a going concern" until he is actually operating the building? Even though he may have been in business for two or three years during the construction of the building?

DEPARTMENT OF THE TREASURY,
Washington, D.C., June 12, 1980.

Hon. RICHARD T. SCHULZE,
House of Representatives.

DEAR MR. SCHULZE: I am writing in response to questions submitted for the record by Mr. Duncan on your behalf concerning H.R. 5729, amortization of start-up expenditures.

A. The "start-up expenditures" to be covered by the bill could, in our view, be defined as any amounts paid or incurred in connection with (1) investigating the creation or acquisition of a trade or business, or (2) creating a trade or business, provided that in either case such amounts would be allowable as a deduction in the year paid or incurred if they were paid or incurred in connection with the expansion of an existing trade or business.

B. As our answer to A. indicates, there would be no fixed "starting date" for start-up expenditures. Provided the above definition is satisfied, expenses incurred, e.g., prior to filing of a partnership agreement or corporate charter, could be amortizable.

C. We believe amortization should begin with the month in which "the business begins." This is the same rule as in section 248 of the Code, concerning organizational expenditures of corporations, and section 709, concerning organization and syndication fees of partnerships. The determination of the date a business begins presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. Normally, a business will be deemed to have begun if its activities "have advanced to the extent necessary to establish the nature of its business operations." See Treasury Regulations Section 1.248-1(a)(3). In the case of expenditures in connection with investigating the acquisition of a trade or business, the date of acquisition would control.

D. Expenses incurred during construction of an office building could qualify for amortization under the definition described in A., even though the operation of the building did not commence until a later year. The election to amortize, however, would have to be made in the year the business began, as described in

C. above. A prudent taxpayer would presumably make the election in the earliest year in which it is proper to do so.

I would be happy to answer any further questions you may have as this legislation progresses.

Sincerely,

DANIEL I. HALPERIN,
Deputy Assistant Secretary
(Tax Legislation).

Mr. COTTER. Mr. Chairman, I have a couple of questions on H.R. 6824 if it is appropriate?

Mr. ROSTENKOWSKI. All right; but Mr. Vander Jagt, would you go ahead and then we will go to your questions?

Mr. VANDER JAGT. Mr. Chairman, I need the Treasury witnesses to help me understand a problem that I have.

Mr. GUTMAN. We will try.

Mr. VANDER JAGT. I have a constituent who wanted to sell the stock of the business he owned. However, for a variety of reasons sold his business' assets instead of its stock.

Can you explain to me with a little more clarity what my problem is and what the Department suggests? I understand the Treasury has been contacted and has no objection and our staff has no objection but I would like you to give me that?

Mr. GUTMAN. I will try to do that for you. Where a corporation wants to liquidate under a special tax provision, section 337, which permits the corporation to sell assets and not recognize any gain, then the only gain which is recognized is the distribution of the net proceeds to the shareholder. When a corporation does that under present law, if it sells its assets and receives back an installment obligation, the distribution of that installment obligation doesn't trigger gain at the corporate level but the shareholder has to take into account the fair market value of the obligation when it comes out. So if a corporation adopts a section 337 plan today, sells assets, gets back an installment note and distributed that installment note, the shareholder has to recognize the gain on that installment note even though the shareholder has no cash.

If that same shareholder had sold stock on the installment method, he would take the gain into account ratably as he receives it. That was the situation which Mr. Rushing faced so he sold his stock, I believe to a trust for the benefit of his children. The trust got a stepped up basis, he got installment sales treatment, and when the installment obligations were distributed out of the corporation, the trust's basis was equal to the face amount of the notes issued to Mr. Rushing.

The bill changes the treatment of a section 337 liquidation so there is no need any longer to engage in that Rushing-type transaction. That is essentially the problem your constituent has. He adopted a section 337 plan, apparently prior to the effective date, sold assets on the installment method and would still be in the present law situation.

Mr. VANDER JAGT. A change of the effective date of the bill, would as I understand it, solve the problem.

Mr. GUTMAN. In the section 337 area alone, that would not be a serious problem. That is, as long as that date is the same date as we have for the anti-Rushing rule which would be March 31.

Mr. VANDER JAGT. Thank you.

Mr. COTTER. Thank you very much.

Mr. Halperin, I have a couple of questions on H.R. 6824 which Treasury is apparently opposed to. I fail to see why you are so opposed to them. I don't know of any abuses in this particular area and for many tax exempt organizations it is really the only vehicle which they can use to attract a certain class of employees. Could you tell me where the abuses are or where the real loss to the Treasury is as far as revenue is concerned?

Mr. HALPERIN. What we are dealing with here is the question of whether or not it is possible to avoid current tax on salary or earnings.

Mr. COTTER. But you get it anyway?

Mr. HALPERIN. But the deferral is a tremendous benefit. We have a great number of provisions dealing with when salary should be taxed, and we have set up a system where normally the only way one can achieve deferral of taxes on salary is by the use of qualified plans. We have elaborate systems for qualified plans and we have individual retirement accounts, IRA's, with \$1,500 limits on the amount that can be put aside. In effect, if you are employed by a tax exempt organization, the qualified plan limits are meaningless and the IRA limits are meaningless, and you can say to your employer, don't pay me \$5,000, \$10,000, or \$20,000—keep it back and pay it to me at a future date. That is a tremendous advantage and it is usable only by high-paid employees.

Under ERISA you cannot do that for low-paid or moderately paid people because those types of plans have to be funded and don't get this tax benefit.

Mr. COTTER. This is exactly right, but how does an organization like a nonprofit hospital who has to attract the high salaried person such as a surgeon, how can he attract them otherwise? The hospital itself does not have the assets or the money to set up a plan within their own structure.

I think it is very useful for these nonprofit organizations. I can't see where there are that many instances of it being used where there is any real abuse in this particular area either.

Mr. HALPERIN. We have provided in the law a number of tax benefits to nonprofit hospitals in order to encourage people to make contributions to them. In fact, we also have a deferred compensation device available through the so-called section 403(b) annuities where they can achieve deferral in the case of section 501(c)(3) organizations. People who possibly might be benefitting under the legislation that you have sponsored would be employees of trade associations and other organizations that do not have the benefit of section 403(b) annuities. It is hard to argue for special benefits in those circumstances.

Mr. COTTER. Haven't most of the courts and various IRS rulings upheld these deferred compensation plans? Where are the legal precedents for IRS regulations?

Mr. HALPERIN. Well, the issue, Mr. Cotter, is whether if somebody says, "Don't pay me my salary" and they say that before they actually work, before they actually perform the services, does that preclude constructive receipt. Prior IRS rulings said yes to that question, but I don't think any of the cases really faced it in the context of the potential for tax avoidance that we are talking about.

Mr. COTTER. If this becomes a serious problem, let us address it in the future but in effect what you people are doing is by regulation and rules writing law.

Mr. HALPERIN. There is no question that large amounts of money have been deferred by people in these circumstances.

Mr. COTTER. It appears to me that the lawmaking body should be the Congress and not the Treasury Department or the IRS. This is what you are doing. You are usurping the prerogatives of the Congress.

Mr. HALPERIN. As we have indicated, we would agree and former Secretary Blumenthal stated in a letter to this committee a couple of years ago, 2 years ago, we believe a legislative solution is preferable. Congress did legislate in this area in 1978.

Mr. COTTER. But what you want is your own way in this thing. You are opposed to this when we are attempting to address the problem but you want to write your own rules and regulations.

Mr. HALPERIN. No sir, as we have indicated in our testimony, S. 511 has been introduced on the Senate side and we are generally supportive of that bill. We see no reason to favor tax exempt organizations over State and local governments. The 1978 Revenue Act set forth a very careful limitation on the benefits that can be obtained by employees of State and local governments. Although these limits weren't all that we asked for, and while we continue to believe that some kind of nondiscrimination test would be useful in this area, in any event we believe those provisions are certainly more limited than what would be permitted under H.R. 6824, and if legislation is going to be enacted, then we believe that the preferable route is the adoption of S. 511, and not this bill.

Mr. COTTER. Didn't the 1978 act resolve most of the controversy surrounding the deferred compensation in the government sector and that already substantially restricts deferred compensation there?

Mr. HALPERIN. It resolved the problem with regard to employees of State and local governments and employees of tax paying organizations. It left open the question of tax exempt associations. That was a conscious decision, at least I thought it was, and I thought it was a conscious decision to leave the treatment of tax exempts to future consideration in the regulatory process or otherwise.

I don't think that there are currently any limits on the amount of deferred compensation in an unfunded plan that can be provided for high-paid employees of tax-exempt organizations. ERISA prevents unfunded plans for the rank and file employee and that makes the potential abuse even worse because we have a situation where not only is there a bias favoring the high paid but a prohibition against covering everybody. This is very troublesome.

Mr. VANDER JAGT. In essence, what the gentleman is asking is that the employees of nonprofit organizations have the same benefits and opportunities as employees of profitmaking organizations.

Mr. COTTER. Absolutely.

Mr. VANDER JAGT. I thank you for yielding.

Mr. HALPERIN. If I could respond to that, we have attached as an appendix to my statement a chart which illustrates the tremendous difference between the treatment of compensation for employees of tax exempt organizations and employees of taxable organizations. If

either organization is going to pay salaries, then under the normal rules of tax deduction, they will both have to take in enough receipts to cover the amount of the salary that they are going to pay. So if they are going to pay someone \$10,000 a year, the taxable employer will have to pick up \$10,000 in receipts and the tax exempt also will have to come up with \$10,000.

Mr. COTTER. But most of your nonprofits don't have that money.

Mr. HALPERIN. Certainly nonprofits do not pay as much as taxable organizations. I am painfully aware of that.

The point is if the taxable organization is going to provide deferred compensation without taking a tax deduction, which it has to do under present law, it has to take in more money than it pays out to the employee because it is going to have to pay the tax first and then pay the salary. That is what that appendix shows.

Mr. ROSTENKOWSKI. I would like to make a comment or two on a couple of the bills.

It really pleases me to see Treasury support Mr. Conable's bill on the clarification of treatment on startup costs. I think here is another small area in the Code where we can make a positive improvement of general application. I also note your general approval of H.R. 6140, the chairman's and my pension bill. I believe there is a loophole to be plugged. The staff will be directed to work with you in addressing any technical and other questions.

If there are no further questions, I would like to thank you and Mr. Gutman for joining us here this morning.

Our next witnesses are Mr. Walker, Mr. Delaney, Mr. Ginsburg, Mr. Lerner, Mr. Davis, Mr. Murdock, and Mr. Layman.

Welcome to the subcommittee, gentlemen. We are pleased you have taken the time out of your busy schedules to join us in addressing some of the problems that we face here in the Government.

I would like very much to ask if your statement is longer than the time allocation given you, that you summarize. I would also suggest that if you wish to react to the statements of your fellow panelists, then you might comment on them as well in the question-and-answer period.

We will begin with Mr. Walker and follow through in the order which I have called you gentlemen to this panel discussion.

If you would be kind enough, please identify yourself with your address.

Mr. Walker, if you will begin, we welcome you to the subcommittee. It is nice to have you back with us.

STATEMENT OF CHARLES M. WALKER, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. WALKER. It is always a pleasure to return to this chamber. I am Charles M. Walker, chairman of the Section of Taxation of the American Bar Association. We would like to enthusiastically support H.R. 6883.

The focal point of my testimony is tax simplification. This is a cause that has been espoused by the tax section for years. The goal of simplification has been long sought by many groups and individuals both in and out of government.

But it is an illusive goal, indeed it is a goal that even defies adequate definition. Yet this bill in my opinion and in the opinion of many other members of the tax section achieves a significant piece of simplification. It explicitly simplifies the law in several respects. Eliminating the 30 percent down payment rule is a clear example. It also simplifies the law in the sense that it clears up a portion of deferred payment reporting tax rules which for many years have been confusing, uncertain, and unfair.

Some of the unfairness is seen in the fact that taxpayers with large amounts at stake can afford to structure complex transactions to achieve the advantage of deferring tax on gain by using the installment reporting method, whereas less advantaged taxpayers do not or cannot do the same.

The *Rushing* case to which Mr. Gutman has referred is a prime example. Mr. Rushing's tax problem was a very real one. His solution was a complicated one. It was not designed to, nor did it, produce unfair results. And it worked, although not without litigation to make it stick.

But the technique he used when used in other factual settings is thought by many persons both in and out of government to produce unfair results. The bill addresses the Rushing problem by responding directly to it through making installment treatment available in section 337 liquidation situations. Thus taxpayers in Mr. Rushing's shoes would not have to use his complicated arrangement to achieve the same results. That is simplification.

But the bill goes on to block the perceived unfairness resulting from use of the Rushing technique in other situations.

Is that simplification, or is it reform, or is it both? The fact is that in the tax legislative process a simplification advocate, not surprisingly, is required to pay a price to gain the agreement to the simplification proposal by interests which at the same time advocate relevant reform. There were such interests in the case of this bill. They were varied.

The principal but not the only advocate was the Treasury. The tax section feels that, without the reform element, the simplification element would not be achievable. Moreover, without the reform element not only in the Rushing situation but possibly in other elements of the bill, the tax section feels that it would not have been possible to achieve even the explicit and wholly noncontroversial simplification objectives in the installment sale area.

In summary, the tax section recognizes that the simplification road is likely to be a bumpy one in which compromises will have to be made. The compromises we see in this bill do not significantly detract from its simplification virtues, and in any case we agree with the reform aspects of the bill.

Thus as a simplification measure alone, or as a mixed package, we support the bill and do so enthusiastically. There is much more to the bill than I have mentioned. I will leave to Mr. Ginsburg and others a discussion of its other provisions and a further discussion of the points I referred to only briefly.

The development of this bill and a companion bill in the Senate which is S. 2451 has established what I think is an exciting precedent.

Not only does it achieve significant simplification but it is the direct result of a unique cooperative effort which brings to the bill a consensus of key members of congressional tax writing committees and cognizant staff members, Treasury Department, staff of the Joint Committee on Taxation and professional tax practitioner groups.

Enactment of the bill will encourage the cooperative effort which produced it to be repeated in other areas of the tax law which badly need simplifying and clarifying.

The unique cooperative effort which produced the bill was made by many people. In making its contribution the tax section worked through several of its committees and we were extremely fortunate to have available the talents of Martin Ginsburg. Not only was he functioning as vice chairman of our special committee but has been acting on behalf of the committees of two other bar associations. By wearing all three hats he has been the focal point for discussion on ingredients of the legislative proposal and as such was in touch with the cognizant representatives of the American Institute of Certified Public Accountants, the Treasury Department, the staff of the Joint Committee and the staffs of this subcommittee and of the Senate Finance Committee.

It is the judgment of the tax section, shared I am sure by other participants in the venture, that the proposed legislation solves the problems it has addressed in ways which are beneficial both to taxpayers and to the Internal Revenue Service and has done little if any mischief to either side.

We sincerely hope this legislation will be enacted this year so that we may see a successful culmination of this unique effort. I commend your subcommittee, Mr. Chairman, and your staff for proceeding so expeditiously with this bill.

That concludes, Mr. Chairman, my comments on this bill. The taxation section has comments on three other measures before this subcommittee, and I would like to comment on them at an appropriate time.

Either I can comment on them now, and all of my comments are designed to stay within the total 10 minutes, or I can follow your lead on how to do it.

Mr. ROSTENKOWSKI. If you would like to conclude your observations on the other bills as well, then we will go to Mr. Ginsburg.

H.R. 6247

Mr. WALKER. If I can proceed to H.R. 6247 just briefly, I can say that the tax section supports that bill but we do suggest the consideration of a few modifications which we think will improve the relief which the bill is designed to provide.

The modifications are discussed in some detail in our written statement and I will mention only some of them briefly now.

One relates to whether the spouses must live apart for the entire year. The question is whether some accommodation should not be made for pro-ration of income received while the spouses were living apart or to require something less than a full year of living apart.

Another question is whether both spouses or only one of them need have earned income during the year.

Another is how to handle the investment income that is community income.

Another is to suggest that a de minimus rule be considered when requiring that none of the earned income be transferred to the spouse claiming the relief provided by the bill.

There are other modifications which could be considered which I don't have time to mention now but which are referred to in our written statement.

H.R. 6140

Moving then to H.R. 6140, which deals with pension plans for professional corporations, I would like to state at the outset that the problem with which the bill deals would not be faced in nearly the degree it presently is if Congress took the simple and logical step of enacting the same pension tax rules for self-employed persons, including members of the partnerships, that apply to corporate employees. The American Bar Association has adopted precisely that position. In 1973 it approved a tax section recommendation that the retirement plan rules be rewritten to eliminate all distinctions between common law employees and self-employed individuals and to eliminate any distinctions based on ownership.

In 1978 the association reiterated that position and also recommended that those distinctions be eliminated with respect to all other employee benefits. And further that adjustments for increases in cost of living for self-employed persons should be provided just as they are with respect to plans for employees.

These recommendations would reduce complexity and provide benefits to self-employed persons without subjecting them to the cost and distortions of using the corporate form in areas where from a business standpoint it is unnecessary and undesirable.

As to the specifics of H.R. 6140 the tax section formed a task force to study the issue and that task force concluded that the results of the tax court cases, they haven't been referred to by name previously so I will mention them now so they can be recognized, one is *Kiddie* and the other is *Garland*. Those two tax court cases produced a result which I think we agree is contrary to good tax policy and should be legislatively reversed.

The task force that we have also concluded that there are some defects in H.R. 6140 which this committee might wish to consider. First, the bill addresses a limited aspect of a much larger problem. The bill combines a narrow attack on the *Kiddie* and *Garland* situations, with broad delegations to the Treasury Department to handle other situations by regulation. Under the bill a professional corporation and a partnership in which it has a 25 percent or greater interest will be aggregated for pension plan purposes leaving other cases of abuse of the pension nondiscrimination rules by multiple professional organizations to be dealt with by regulation.

We believe that the bill should be improved in several respects. First, it should not deal only with professional organizations. I think Mr. Gutman or Mr. Halperin mentioned this. The multiple problem affects all types of business organizations.

Second, the bill delegates too much authority to the Treasury Department with too little legislative guidance. Rather there should be

a statutory definition of entities to be aggregated for purposes of testing for discrimination. The definition could use a subjective standard coupled with some safe harbor rules, and once defined as such entities, a nondiscrimination test to be applied to them must be developed.

We in the tax section are still working on both the definition and the test, and we would expect in the near future to be able to discuss these with the committee staff and the joint committee staff.

In summary, the tax section supports the objectives of the bill that the *Kiddie* and *Garland* cases reflect bad tax policy which should be reversed.

However, that solution is not simple and the bill in its present form has some problems.

H.R. 5729

Finally, Mr. Chairman, on H.R. 5729, the amortization of startup expenditures, the bill would solve some of the problems encountered when expenditures are incurred or paid in connection with a trade or business prior to the time that the trade or business commences. The American Bar Association in 1976 adopted a recommendation that a new section be added to the Code which would allow amortization of business intangibles in the case of all intangibles used in a trade or business or held for the production of income with respect to which no deduction for depreciation or amortization was allowable.

Although the targets of H.R. 5729 and the association's recommendations are different, the underlying principles are the same. The section of taxation therefore, in addition to urging adoption of the association's recommendations, does support the concept of H.R. 5729. However, for reasons explained in our written statement, some of the definitions in the bill should be readdressed.

We recommend that the phrase "begins business" which is adopted in the bill should be broadened or be made consistent with other somewhat similar provisions in the Code. That would make it more uniform and easy to apply.

That concludes my comments. I do thank you for your attention and the opportunity to speak.

[The prepared statement follows:]

STATEMENT OF CHARLES M. WALKER, CHAIRMAN OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Subcommittee: My name is Charles M. Walker. I am Chairman of the Section of Taxation of the American Bar Association. In that capacity I am pleased to express the views of the Section of Taxation of the American Bar Association with regard to four bills pending before the Subcommittee. These views are only those of the Section and should not, except as specifically indicated, be construed as representing the position of the Association.

I. H.R. 6883—INSTALLMENT SALE REVISION ACT OF 1980

Mr. Chairman, I would like to state that the Section of Taxation enthusiastically supports H.R. 6883.

It is important, as a preliminary matter, to establish the direct relationship between this legislation and the matter of simplification of the tax law. Simplification has been a long sought goal. H.R. 6883 is an explicit implementation of that goal. While much, much more simplification is needed, introduction of that bill and a companion bill in the Senate (S. 2451) has established an exciting precedent. Not only does it achieve significant simplification, but it is the direct result

of a unique cooperative effort which brings to the bill a consensus of key members of the Congressional tax writing committee and their cognizant staff members, the Treasury Department, the staff of the Joint Committee on Taxation and professional tax practitioner groups.

Enactment of H.R. 6883 will encourage the cooperative effort which produced it to be repeated with other areas of the tax law which badly need simplifying and clarifying.

Members of the ABA Tax Section are among representatives of the tax practitioner groups which participated in the cooperative effort. For over a decade our Section has been grappling with tax simplification efforts—efforts which until now seem to have been steadily losing ground to the enactment of ever increasingly complex tax laws.

Testimony of other members of the Tax Section on previous occasions¹ has recounted some of the Section's efforts at simplification.

In 1976, the following recommendation of the Tax Section was approved by the Board of Governors of the American Bar Association:

"It is recommended that (1) the Congress simplify the internal revenue laws so that they can be easily understood and complied with and fairly and consistently administered; (2) the Ways & Means and Finance Committees adopt and announce a scheduled long-range program to achieve such simplification; (3) those Committees employ to the maximum extent possible the resources and experience of the Treasury Department in designing and developing such a program; and (4) the Congress designate and establish an appropriate body of advisors, whether it be a separately funded section of the staff of the Joint Committee on Internal Revenue Taxation, a separate commission, or some other appropriate organization, to assist in this program by assembling and analyzing basic information and advising the tax-writing committees of various alternatives."

In implementing that resolution, the Tax Section has been authorized to speak for the American Bar Association on the matter of tax simplification. Notwithstanding that authorization, however, I am speaking today only for the Tax Section which, as I have said, enthusiastically supports the bill. My unwillingness to speak for the Association is because some portions of H.R. 6883 may be regarded by some Association members as going beyond simplification. Indeed, some members of one of the committees dealing with this proposal, although unequivocally supporting it, object to classifying it as simplification. For reasons stated below, other members of the Tax Section, including the chairmen and members of other committees dealing with the proposal, and I, as Chairman of the Section, not only support the proposal on its merits but, also for reasons stated below, regard it as simplification.

As I have said, H.R. 6883 has established a precedent. It might be described as a first concrete blow for practical real-life, down to earth, tax simplification. Although only a pebble in the pond, it can have a ripple effect which in time will embrace larger and larger segments of the tax law. In this slowly expanding process, if not through a longer range and bolder effort towards simplification,² we will be able to contribute to the simplification which the tax system must have in order to retain its viability and to prevent damage to its integrity which is being seriously threatened by public attitudes of disrespect and non-compliance.

The legislation under consideration, as I mentioned above, is the product of a unique process—a "first." Representatives of the Tax Section of the American Bar Association, in cooperation with tax committees of the New York State and City Bars and the Federal Tax Division of the American Institute of Certified Public Accountants, originally developed a proposal to simplify the installment sale provisions of the Internal Revenue Code. Each of the groups functioned in accordance with its organizational procedures. Speaking for the Tax Section, this

¹ Statement of Lipman Redman, presented to the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee, June 22, 1979, Washington, D.C.

Statement of John S. Nolan before the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee, June 22, 1979, Washington, D.C.

Statement of Lipman Redman, presented to the Subcommittee on Select Revenue Measures, House Ways and Means Committee, July 27, 1979, Washington, D.C.

Debt Management Generally of the Senate Finance Committee, June 22, 1979. See also the 1977 Treasury Department publication, "Blueprints for Basic Tax Reform," referred to in Mr. Nolan's statement and in testimony of witnesses before the Ways & Means Committee on H.R. 5665 (96th Congress, First Session, Serial 96-50).

² Urged in the statement of John S. Nolan before the Subcommittee on Taxation and

meant participation by members of our Special Committee on Simplification and our substantive committees dealing with tax accounting problems and sales, exchanges and basis, those subjects being intimately involved in the implementation of the installment sale provisions. We were extremely fortunate to have available to us the talents of Martin Ginsburg, Esq., who, somehow, has survived his experience—and with good grace. Not only was he functioning as the Vice Chairman of our Special Committee on Simplification, but has been acting on behalf of the Committee on Taxation of the Association of the Bar of the City of New York and on behalf of the Tax Section of the New York Bar Association. By wearing all three hats, he has been the focal point for discussion on ingredients of the legislative proposal and as such was in touch with the cognizant representatives of the AICPA Tax Division, the Treasury Department, the staff of the Joint Committee on Taxation, and the staffs of this Subcommittee and of the Senate Finance Committee.

As discussion ensued among all the above participants, it soon became evident that the "barebones" simplification first envisaged for Section 453 would develop a good bit of flesh designed not only to achieve explicit "simple" simplification, but simplification in the larger sense of clearing up portions of deferred payment tax reporting rules which, for many years, have been confusing, uncertain and unfair. Some unfairness was seen in the fact that taxpayers with large amounts at stake could afford to structure complex transactions to achieve the advantage of deferring tax on gain by using installment reporting, whereas less advantaged taxpayers would not or could not do the same.

After numerous meetings and discussions, preparation of numerous memoranda addressing certain aspects of the problem and responses thereto, there finally emerged legislation which has been endorsed by all the participants. The proposed legislation, while adding words to the Internal Revenue Code, and, in that sense, is not simplifying, nevertheless resolves and disposes of many existing problems. Consequently, the bill clearly deserves the classification of simplification even though, in the eyes of some, the changes are more reform than simplification in a very real and practical sense.

It is the judgment of the Tax Section, shared, I am sure, by the other participants in the venture, that the proposed legislation solves the problems it has addressed in ways which are beneficial both to taxpayers and to the Internal Revenue Service, and has done little, if any, mischief to either side.

Legislation similar to H.R. 6883 is pending in the Senate (S. 2451). I intend to testify in support of S. 2451 in precisely the same fashion as I am here. If expectations can be realized, I hope this legislation will be passed by both Houses and enacted this year so that we may see a successful culmination of this unique effort.

I commend your Subcommittee, Mr. Chairman, and your staff for proceeding so expeditiously with the matter.

I will leave to Mr. Ginsburg and others commentary upon specific provisions of the bill. While I am familiar with them, Mr. Ginsburg's intimate involvement with each of the provisions makes him better qualified than I to discuss them and to answer any questions about them.

II. H.R. 6247—COMMUNITY INCOME WHERE SPOUSES LIVE APART

H.R. 6247, introduced by Representative Gibbons, provides that, in certain cases where married individuals live apart, community property laws will not apply for federal tax purposes. The Section of Taxation of the American Bar Association favors the enactment of H.R. 6247 or legislation to achieve a similar result.

Eight States, the Commonwealth of Puerto Rico and numerous foreign countries have community property laws which provide that the community income of both spouses is owned equally by each spouse. In general, community income is any income earned during marriage or any income derived from an asset acquired during marriage, although the specific rules vary among jurisdictions. Under federal tax law, each spouse is taxable on one-half of the community income. Most spouses residing in community property states do in fact share the community income and file joint returns. Thus, this rule does not usually result in the imposition of federal income tax liability on a spouse who does not benefit from the community income.

However, when spouses do not live together, and one of them does not in fact enjoy a portion of the community income, that spouse is nonetheless subject to tax on half of the community income despite the lack of control over or benefit from that income. Indeed, the spouse may not even know that the income exists. This may result in the assertion against that spouse of an unexpected tax liability that the spouse is unable to satisfy.

H.R. 6247 would rectify this inequity where spouses live apart for the entire year, do not file a joint return and do not transfer earned income between each other. In these circumstances, the income would generally be taxed only to the spouse to whom attributable.

The Section of Taxation of the American Bar Association supports enactment of this legislation but does recommend that it be modified in certain respects identified below.

H.R. 6247 identifies those taxpayers eligible for its benefits by providing objective standards in a new section 66. Subsection (a)(2) requires that the spouses "live apart at all times during the calendar year." While this test would be easy to administer, it may impose a hardship on those spouses who live together for only a brief portion of a year. For example, a spouse could be taxable on one-half of the income earned by the other spouse for the entire year by virtue of having lived together for only one day. The Committee may wish to explore the possibility of changing the time period, such as requiring six or nine months of continuous separation. An alternative approach would be to relate the amount of income which qualifies for special treatment under section 66 to the time which the spouses were separated. For example, under Louisiana law, a spouse is taxable on the community income only for that portion of the year preceding the date on which an action for divorce is filed. See *Brent v. Commissioner*, 70 T.C. 775 (1978).

Subsection (a)(2) also requires that the couple not file a joint return for the taxable year. Thus, if the spouses have filed a joint return, they would not qualify under H.R. 6247. However, the innocent spouse rules of section 6013(e) may protect a spouse who signed a joint return. Nevertheless, some taxpayers will not qualify for the innocent spouse protection and will, by reason of having filed a joint return, lose the benefits of H.R. 6247. The Committee may wish to consider easing this rule by providing that the filing of a joint return does not conclusively indicate that any community income was shared by the spouses.

Subsection (a)(3) requires that the spouses "have earned income for the calendar year which is community income." This paragraph could be interpreted to require that each spouse have earned income. The better approach may be to specify that only one spouse need have earned income.

It is not clear why subsection (a)(3) requires the presence of earned income. Unearned income may be community income and may be present in substantial amounts in a year when no income is earned. Therefore, a spouse could, if the bill were enacted in its present form, receive over half of the community income and be taxable on only half—alternatively, a spouse could receive none of the community income and yet be taxable on half of it. Neither result would be equitable. The Committee may wish to consider modifying subsection (a)(3) to require only that the spouses have community income, without regard to the character of that income.

Subsection (a)(4) requires that "no portion of such earned income" be transferred between the spouses during the year. The language attempts to make administration as easy as possible by prohibiting completely the transfer of earned income between the spouses. The Committee may wish to consider adopting a de minimus rule, allowing the transfer of an appropriate amount such as \$500. This would prevent an informed spouse enjoying income from taking advantage of an uninformed spouse through the device of a minimal transfer of income to the latter.

Subsection (a)(4) is limited to the transfer of income earned in a particular year. It may be difficult to establish that a particular amount of income transferred between the spouses was either (1) earned, or (2) earned during a particular year. If, as suggested above, the term "earned income" is expanded to include all community income, the first problem is overcome. Even if this is done, however, the problem of establishing the year in which the income is derived remains. The Committee may wish to consider the desirability of a statutory presumption that any transfer between spouses is deemed to come

from the community income for the year of transfer unless otherwise established. This would ease the problem of administering the statute.

Subsection (a)(4) prohibits indirect transfers of income between spouses. In many cases, a separated spouse may provide amounts for the support of children, voluntarily or under a court order. The Committee may wish to consider whether child support constitutes an "indirect" transfer and, if so, under what conditions, if any, child support should be excluded.

To the extent that the conditions of paragraph (1)-(4) of subsection (a) are satisfied, the community income is to be taxed as provided in existing section 879, i.e., it is to be taxed to the spouse to which attributable. This reliance on section 879 is commendable. The Treasury Department has recently published final regulations under it and has been developing experience in administering this section since 1977. This experience should facilitate implementation of the new section 66.

III. H.R. 6140—PENSION PLANS OF PROFESSIONAL CORPORATIONS

H.R. 6140 is designed to prevent certain abuses of the pension plan provision of the Internal Revenue Code relating to professional corporations. These abuses flow from the results in two Tax Courts cases, *Thomas Kiddie, M.D., Inc.*, 60 T.C. 1055 (1978), and *Lloyd M. Garland, M.D., F.A.C.S., P.A.*, 73 T.C. No. 2 (October 4, 1979). In those cases, the Tax Court approved an arrangement under which professionals can, by separately incorporating their individual practices, evade the nondiscrimination requirements of the Code which are imposed for the protection of rank and file employees in cases of qualified pension and profit sharing plans.

Before commenting on H.R. 6140 I would like to take this opportunity to point out that the problems with which the bill deals would not be faced in nearly the degree it presently is if Congress took the simple and logical step of enacting the same pension tax rules for self employed persons, including members of partnerships, that apply to corporate employees.

The American Bar Association has adopted precisely that position. In 1973 it approved a Tax Section recommendation which provides that qualified employee benefit plan provisions of the Internal Revenue Code should be rewritten (1) to eliminate all distinctions between common law employees and self-employed individuals, (2) to eliminate any distinctions based upon ownership and (3) to provide that the special social security integration rules for owner/employees be eliminated or raised.

In 1978, the Association's Special Committee on Retirement Benefits Legislation presented a recommendation, approved by the House of Delegates, that the Code be amended to eliminate the difference between the treatment of self-employed persons and employees with respect to qualified employee benefit plans and all other employee benefits; that, in any event, the limitations on contributions to or benefits from qualified employee benefit plans should be the same for both employees and self-employed persons; and further, that adjustments for increases in cost of living for self-employed persons should be provided, just as they are with respect to plans for employees.

These recommendations would very substantially reduce complexity and provide comparable benefits to self-employed persons without subjecting them to the cost and distortions of using the corporate form in areas where, from a business standpoint, it is unnecessary and undesirable.

Getting now to the specifics of H.R. 6140, shortly after it was introduced in December of 1979, the Section of Taxation formed a task force to study this issue. That task force immediately concluded that the result in the *Kiddie/Garland* cases was contrary to good tax policy and should be reversed. The task force also concluded, however, that there are some defects in H.R. 6140 that this Committee may wish to consider. I will identify some of these defects and will suggest approaches for alternative solutions.

H.R. 6140 addresses a limited aspect of a much larger problem. The tax laws provide important incentives for employers to maintain pension plans which cover rank and file employees. Some employers, however, have endeavored to obtain for themselves the tax benefits of qualified pension plans without also providing coverage to their rank and file employees.

The use of multiple business entities has been recognized as a technique for avoiding the nondiscrimination requirements of the pension tax laws. Some corporations have formed service companies to employ managers. Other corpora-

tions have formed joint ventures to employ rank and file employees. In each case the objective has been to provide different pension benefits to the employees of the different entities.

The *Kiddie/Garland* cases are an example of this multiple entity problem. In them, each physician formed a professional corporation which in turn became a member of a partnership to practice medicine. The professional corporation employed only the physician. All of the other personnel were employed by the partnership. In each case the Tax Court held that the professional corporation could provide pension benefits to the physician which were better than the benefits provided to the employees of the partnership. The net result was that the physician obtained the substantial tax benefits of an attractive pension plan which benefited him but not his staff.

Congress addressed the multiple entity problem when it enacted ERISA, but the solution did not extend as far as the *Kiddie/Garland* problem. Section 414 (b) and (c) of the Code provide that a controlled group of entities will be treated as one employer for pension plan coverage purposes. For this purpose, a controlled group includes a partnership and a partner having more than a 50 percent interest in the partnership.

This rule does not reach the *Kiddie/Garland* situation because none of the multiple professional corporations had more than a 50 percent interest in the partnership. If §§ 414 (b) and (c) had applied, the pension plans in the *Kiddie/Garland* cases would have failed. The professional corporations and the partnership would have been considered one employer, and any pension plan established by that aggregate employer would have had to cover the lower-paid employees adequately.

H.R. 6140 combines a narrow attack on the *Kiddie/Garland* situation with a broad delegation to the Treasury Department to handle other situations by regulation. Under the bill, a professional corporation and a partnership in which it has a 25 percent or greater interest will be aggregated for pension plan purposes. Other cases of abuse of the pension nondiscrimination rules by multiple professional organizations are to be dealt with by regulation.

The Tax Section believes that H.R. 6140 should be improved in several respects. First, it should not deal only with professional organizations. The multiple entity problem is universal, affecting all types of businesses and all types of business organizations. There are indications that nonprofessional business enterprises can be expected to seize upon the *Kiddie/Garland* cases to avoid the nondiscrimination requirements. The Tax Section recommends that more comprehensive legislation should be enacted.

Second, H.R. 6140 delegates too much authority to the Treasury Department with too little legislative guidance. The Secretary's regulations are to deal with all abuse situations that involve more than two entities or less than a 25 percent ownership interest. However, the bill specifies no guidelines for those regulations. It does not come to grips with other difficult questions presented by the multiple entities issue. For example, it does not apply to self-insured medical reimbursement plans and to cafeteria plans which are subject to the same potential for abuse.

The multiple entities issue presents two very difficult technical problems. The first problem is to define those entities which are to be aggregated for purposes of testing for discrimination. The second is to determine the method of testing for discrimination once the pertinent entities have been identified.

H.R. 6140 attempts to define multiple business entities by a combination of an objective statutory test and a subjective test to be promulgated by regulation. While we agree that an objective test cannot be the sole solution, we think that the formulation of a subjective definition is too important a question to be delegated to the Secretary without guidelines.

An objective definition must be inherently defective because it will not cover all abuse situations. Even a definition which aggregates a partnership and any professional corporation holding a 5 percent or greater interest in the partnership will not completely solve the problem. Such a rule would not, for example, encompass many large accounting, medical, and law partnerships.

For that reason, a subjective definition must be developed. The challenge is to design one which will prevent abuse but at the same time provide a degree of certainty. These dual goals can be attained by combining the subjective definition with some safe harbor rules.

The Tax Section task force, which I alluded to earlier, is working on such a definition. At the present time, our inclination is to recommend a two-step

"formed or availed of" definition. That is, entities engaged in a single trade or business would be aggregated for pension tax purposes if one of the separate entities was formed or availed of to avoid the nondiscrimination requirements. This definition would be combined with two objective safe harbor rules which would not differentiate between large and small entities. The details of this proposal have not been refined yet.

As I noted earlier, a second important issue is to identify the nondiscrimination test that is to be applied to entities identified by the first test. There are at least two distinct nondiscrimination tests which can be applied.

One approach is the "best plan approach." Each entity within a multiple group of entities having rank and file employees is required to offer its employees pension benefits comparable to those of the best plan in the group. This test may present problems because it is very difficult to determine if plans are comparable.

An alternative approach, in partnership situations, would be to require each partner to provide benefits, on a pro rata basis, to all employees of the partnership. A problem with this approach is that the employee would have to look to several plans for his benefits. This approach also suffers from the fact that it has limited applicability beyond the partnership situation.

In summary, the Tax Section supports the objectives of H.R. 6140. The *Kiddie/Garland* cases reflect bad tax policy and should be reversed. However, the solution is not simple, and H.R. 6140 has some problems. The Tax Section is actively engaged in refining the details of its proposed legislative solution to solve the *Kiddie/Garland* problem. Within the next two months we should be ready to discuss our proposal with the Committee's staff and the staff of the Joint Committee on Taxation.

As stated at the beginning of the comments on the *Kiddie/Garland* matter the tax policy problems with which H.R. 6140 deals would not be faced in nearly the degree it presently is if Congress were to adopt the American Bar Association's position that the retirement benefit tax rules applicable to corporate plans should be applied to plans of self employed persons, including members of partnerships.

IV. H.R. 5729—AMORTIZATION OF STARTUP EXPENDITURES

H.R. 5729 would solve the problem encountered when expenditures are paid or incurred in connection with a trade or business prior to the time that the trade or business commences. The expenditures must generally be capitalized because they do not qualify under Section 162(a) as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *". If the anticipated life of the trade or business, once started, is reasonably determinable, the capitalized expenditures may be amortized over that life. However, in many cases, the capitalized expenditures are not amortizable because the taxpayer is unable to determine the period over which they benefit the trade or business.

The Service raises this issue on audit with increasing frequency. The Service also takes a restrictive view as to when a business is deemed to have commenced, arguing in many cases that the business does not commence until it can actually sell a product or service. Many expenditures which are ordinary and necessary must be and are incurred prior to that time.

The American Bar Association has adopted a Tax Section recommendation (Legislative Recommendation No. 1975-1) that a new section be added to the Code which would allow amortization of business intangibles. The proposed new rule would extend to all intangibles used in a trade or business or held for the production of income, with respect to which no deduction for depreciation or amortization is allowable under other Code sections. Amortization would be allowed over class lives to be determined by the Treasury Department. Class lives would be at least 60 months but not more than 480 months.

While the targets of H.R. 5729 and the Association's recommendation are different, the underlying principles are the same. The Section of Taxation, therefore, in addition to urging adoption of the Association's recommendation, supports the concept of H.R. 5729. We do, however, offer the following recommendations.

H.R. 5729 provides that the amortization period would begin with the month in which the trade or business "starts functioning as a going concern." This leaves open for controversy identification of the point at which a trade or business begins to function as a going concern. Moreover, it departs from the formulation already adopted in the Code in closely analogous situations.

Sections 248 and 709 allow respectively the amortization of corporate and partnership organization expenditures. Under both sections, amortization begins in the month in which the entity "begins business." The Treasury Department regulations under section 248 provide that a corporation is deemed to begin business if its activities have advanced to the point necessary to establish the nature of its business operations, Reg. § 1.248(a)(3). Although regulations have not been issued under section 709, a similar standard presumably will be adopted.

Similarly, section 1372(e)(5), which permits a Subchapter S corporation to have certain passive income in its initial year, defines that year as the year in which the corporation "commenced" the active conduct of a trade or business. The Treasury Department regulations again adopt an activities test, holding that the corporation has commenced business when it first engages in activities "designed or intended" to enable it to engage in business operations, Reg. § 1.1372-4(b)(5)(ii).

We recommend that a similar "begins business" test be adopted in the legislation to identify the commencement of the amortization period. This will make the rule under proposed section 193 conform more closely to existing analogous situations.

Thank you, Mr. Chairman, for your attention and for the opportunity you have given me to speak today.

Mr. ROSTENKOWSKI. Mr. Ginsburg is next.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, COLUMBIA UNIVERSITY, ON BEHALF OF THE COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK; THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION; AND THE COMMITTEE ON SIMPLIFICATION, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. GINSBURG. Mr. Walker does me too much honor, but I was delighted to listen to him, as always.

Mr. ROSTENKOWSKI. We are aware of the amount of time and effort you have devoted to this legislation. We know that you were truly one of the principal architects of this legislation, we are very happy to have you with us.

Mr. GINSBURG. Thank you.

I am not sure I should listen to that while Mr. Murdoch is next to me.

My name is Martin D. Ginsburg. I am the Beekman professor of law at Columbia University School of Law teaching various subjects in the field of Federal taxation. The address of Columbia Law School is 435 West 116th Street, 10027.

For some 20 years prior to joining the Columbia faculty and with a more modest time commitment since joining the faculty, I have practiced law in New York City primarily in the Federal tax field.

I am very pleased to testify this morning with respect to House bill 6883, legislation intended to clarify, simplify, and vastly improve the Federal income tax treatment of installment sales and other deferred payment sales by nondealers.

I appear today in various capacities: Officially, on behalf of the Committee on Taxation of the Association of the Bar of the City of New York and on behalf of the Tax Section of the New York State Bar Association, of both of which organizations I am past chairman, and, individually rather than institutionally, on behalf of the Committee on Simplification of the Section of Taxation of the American Bar Association of which committee I currently am vice chairman.

The three bar association groups I represent this morning jointly have adopted a report analyzing and commenting on H.R. 6883 for submission to this hearing. The joint report extends my testimony today on behalf of these groups. With the chairman's permission, I ask that the joint report and the separate four-page summary of it which also has been distributed this morning be included in the record of this hearing.

Mr. ROSTENKOWSKI. Without objection, that will be done.

Mr. GINSBURG. Also, I prepared a fairly lengthy written statement. The subcommittee's patience is legion but I suspect it is not without limits. I should like to deliver a much shorter version and ask that the written statement also be included in the record.

Mr. ROSTENKOWSKI. Without objection, that will be done.

Mr. GINSBURG. Mr. Chairman, my younger child is addicted to clear statements of a forceful sort. If he were testifying this morning, he would announce this is a super bill and then he would sit down. I will follow his lead in the first. This is indeed a super bill. But I will postpone my departure long enough to explain why we think it is a super bill and urge its prompt enactment.

The legislation under consideration today is short titled the "Installment Sales Revision Act of 1980." On July 27, 1979 the Subcommittee on Select Revenue Measures heard extensive testimony on a predecessor bill, H.R. 3899, by representatives of, among others, the Treasury Department and the institutional tax fraternity, the Bar Association groups and the Federal Tax Division of the AICPA, all of which are again represented here this morning.

Uniformly, the earlier bill was commended in its objective to simplify the tax reporting of installment sales. But the earlier legislative proposal was criticized in two major respects.

First and narrowly, H.R. 3899 proposed to treat the installment sale to a related party, generally known in the tax trade as the Rushing problem, in a Draconian way. No installment method deferral of the seller's tax was to be allowed. All who testified disapproved this approach.

In a related party installment sale, the potential of income tax avoidance resides not in that sale standing alone, but rather in the related purchaser's ability promptly to resell to a third party for cash and, blessed with a high purchase price basis, avoid tax on that cash resale.

Focusing on this reality the Treasury, bar groups and AICPA urged in general terms that a related party installment sale should not be barred but voluntary disposition of the property by the related purchaser too close in time should then trigger the original seller's deferred tax liability.

Second, H.R. 3899 was a legislative recommendation of very narrow compass. The principal changes proposed elimination of the 30 percent initial payment limitation and elimination of the two payment rule, qualified as important, long overdue tax simplification measures.

But in number and quality, the problems of complexity in this important area of tax law vastly transcend H.R. 3899's short list. In advance of last summer's hearing, the staff of the Joint Committee on Taxation prepared an excellent paper cataloging major simplification issues in the tax treatment of nondealer sales for future payment.

At the July 27 hearing representatives of the Treasury Department, the bar groups and the AICPA spoke with unprecedented unanimity. In full agreement on the issues and in essential agreement on the appropriate solutions to those issues, they urged that this subcommittee proceed beyond the narrow confines of the original bill and embrace legislation that would truly simplify, clarify, and reform the area.

Reviewing the written and prior oral statements presented that morning, I enjoyed the rare opportunity of summing up my own testimony this way:

We find ourselves today participating in a rather amazing, if not unique piece of tax legislative business. All of us, the Treasury Department, the Bar Association groups, the AICPA, are out to help clarify and simplify an important confused area of tax law. We find ourselves in agreement on the nature and identity of the real problems. And, subject to what I conceive to be relatively minor differences that can, and I have no doubt will, be worked out with the aid of the staff, we are in substantial agreement on the solutions as well.

It is a marvelous, almost millennial, event when the institutional tax bar, institutional accounting fraternity and Treasury Department come to the Congressional table and announces, "This is an important area of tax law affecting a vast number of taxpayers, it cries out for simplification, the Congressional staff in its excellent July 23 paper has correctly identified the issue, and we are in substantial agreement on the fair and simplifying solutions." A truly marvelous event.

Stimulated by the subcommittee's willingness to entertain more expansive legislation, since last July matters have proceeded in a no less marvelous fashion. Long ago Louis Eisenstein perceptively noted, "Our taxes reflect a continuing struggle among contending interests for the privilege of paying the least." That wisdom too often is reflected in the tax legislative process. One taxpayer or taxpayer group seeks improved treatment, other taxpayers look to share the advantage, the Treasury opposes change or at the least attempts drastically to narrow, and the staff referees an often acrimonious soccer match. But on this special occasion attitudes and dealings were very different and the course of collegial conduct is well reflected in the bill now before you.

On our count, the bill makes 10 significant changes in present law. Every one is an improvement and we unreservedly welcome them all.

One, the two-payment requirement in installment sales is eliminated.

Two, installment treatment is extended to sales for payments that are wholly or partly contingent.

Three, the 30 percent initial payment limitation is eliminated.

Four, the \$1,000 floor amount for qualifying installment sales of personal property is eliminated.

Five, installment treatment is automatic on sales of realty and casual sales of personalty. The rare taxpayer who does not wish installment treatment may timely file an election out.

Six, if a corporation adopts a plan of complete liquidation comporting with section 337, sells asset for installment obligations and distributes those obligations, the shareholders are afforded installment treatment.

Seven, reversing the direction criticized last summer, the bill allows installment treatment on sale to a related party and triggers the deferred gain only if and only to the extent the related buyer voluntarily retransfers the property too early. In general, too early is within 2 years if the property is other than marketable securities.

If time permits, I would like to return to this portion of the bill at the close of my testimony.

Eight, installment treatment is extended to debt obligations received incident to an otherwise tax-free like-kind exchange of property and received incident to an otherwise tax-free corporate reorganization.

Nine, section 1038, which affords nonrecognition benefits to a repossessing installment seller of real property, is extended to the estate or beneficiary of the deceased seller.

Ten, finally, the installment obligation disposition rules as they relate to various forms of cancellation are sensibly clarified.

Properly reflecting the intent of the bill, the staff pamphlet prepared for this hearing makes a number of clarifying points. We agree with all of them and urge that they be appropriately reflected in the committee report.

Experience teaches us that a bill dealing with a 50-year history of unmitigated complexity is bound to be replete with technical problems. Experience, in this case, is a poor teacher. The bill is extremely well drawn. We have only 3 technical suggestions.

One, the term "related party" is defined by reference to the section 318(a) attribution rules. Of all of the rules of this sort now extant in the Code, we find section 318(a) nearest the mark. However, we believe the definition should be refined in the single respect of excluding option attribution under section 318(a)(4). Otherwise, and unintentionally, wholly unrelated persons who are party to a commercially normal cross-option agreement will erroneously be treated as related persons under the statute.

Two, the concept embodied in the proposed treatment of debt obligations received incident to an otherwise tax-free like-kind exchange is exemplary, but the language employed in the bill raises a technical concern. We believe that concern can be obviated in a quite uncomplicated way simply by shortening the pertinent provision, proposed section 453(f)(6), in the manner suggested in our joint bar report.

Three, the proposed treatment of shareholders receiving installment obligations incident to a section 337 corporate liquidation is, in general, excellent. Our only technical suggestion relates to the treatment of liquidating distributions received by a shareholder in two consecutive taxable years.

To properly allocate stock basis between first and second year distributions, the bill requires that the shareholder file an amended return for year-one. An alternative course and one we believe preferable because simplifying is adoption of a "catch-up" approach under which the shareholder reflects all appropriate adjustments in the tax return to be filed for year-two.

We are frank to admit there are good arguments for the amended return approach currently reflected in the bill, just as we believe there are good arguments supporting the catch-up approach we prefer. Either approach will work. We prefer the year-two catch-up simply because taxpayers have enough difficulty filing one return each year. We do not think the generality of taxpayers will view an amended return directive as the triumph of tax simplification.

Now, that is the total of our technical recommendations on the bill.

Sensibly, the bill does not attempt to resolve every anomaly in the taxation of future payment sales. In particular, and again sensibly, the

bill excludes from its coverage a series of conceptually connected issues relating to payment.

We believe these matters deserve separate attention, do not urge that they be treated in the pending legislation but do recommend that on a future date the committee reexamine and appropriately react to this area of disparate tax treatment.

Mr. Chairman, in closing my testimony I should like to return for a few moments to the bill's sensible, tailored treatment of related party installment sales. Under current law there are essentially three different reasons why, for example, father will elect to sell property to son or to a trust for the benefit of children or grandchildren for long deferred installment payments.

First, the property may be the stock of a closely held corporation; there is an unrelated installment purchaser for the corporation's assets who is unwilling to buy the corporation's stock, and father seeks the installment tax treatment that current law affords a sale of corporate stock but does not allow when corporate assets are sold and the notes distributed in a section 337 liquidation.

This is the so-called Rushing problem and the installment sale to a related party who then arranges the installment resale to the real buyer is the Rushing solution. Since the bill cures the problem by allowing shareholder installment treatment in the section 337 context, that reason to make a related party installment sale disappears.

Second, estate planning. Father sells the farm or the family business to son who will operate it and pay the notes over time. Father bequeaths the notes to daughter who will not work the farm or work in the business. Or vice versa: daughter may work the farm or the business and son may go elsewhere. The tax law does not discriminate. Nor does the bill. Considerations of estate planning are permissible considerations under the bill's approach to related party installment sales.

Third, income tax planning. Father sells to son for installment notes; blessed with a high purchase price basis, son subsequently resells for cash. The family group has turned the property into immediate investable funds, but has deferred the tax liability a decade or more. This is the abuse case. The bill approaches it in an eminently reasonable way.

Installment sale to a related party is not barred. If son untimely disposes of all or part of the property, the amount he receives or the value of the transferred property if there is no outside sale is treated as if received by father on the installment obligation.

But double counting is avoided. If son must pay or has paid \$100,000 on the note and sells off part of the property to raise or recoup that \$100,000, the \$100,000 is counted only once.

If the property sold to son is anything other than marketable securities, an untimely disposition is one made within 2 years. After 2 years, resale is not a problem unless during that term son effected a short sale or other risk-avoiding transaction with respect to the property.

For marketable securities there is no 2-year safe harbor. Disposition of the marketable securities while the installment note remains outstanding triggers gain to father but only if and only to the extent the disposition proceeds exceed total payments received by father measured to the end of the disposition year.

Not every disposition within 2 years or later in the case of marketable securities triggers gain to father. If father dies no subsequent disposition by son triggers gain; father's estate thus is not obliged to keep track of son's subsequent activity.

If it is son rather than father who dies, neither the transfer of the property by reason of death nor any subsequent disposition triggers gain. The bill's focus is on voluntary dispositions made too soon. Thus, an involuntary conversion triggers no gain to father.

And, recognizing that there are many other kinds of involuntary disposition and a variety of voluntary transfers that produce no special income tax benefit, the bill authorizes the Commissioner to determine that neither the related party installment sale nor the subsequent early disposition had as one of its principal purposes the avoidance of Federal income tax.

The staff pamphlet, which we heartily endorse, is informative here. It contemplates, as we hope the committee report also will contemplate, instructive Treasury regulations that in appropriate cases will approve son's retransfer of the property by gift or to a closely held corporation in exchange for stock or to a partnership in exchange for an interest in that entity.

As pointed out, the bill provides that the determination of a principal purpose to avoid Federal income tax shall be made by the Internal Revenue Service. That is, absent an abuse of discretion the Commissioner's determination governs.

The bill could have been written differently. It could have said nothing about the method of determination, thereby allowing father to go to court and attempt to shoulder the normal burden of proving erroneous the Commissioner's finding of income tax avoidance purpose.

The institutional tax groups, the bar associations and the AICPA, did not seek that modest litigation advantage. To the contrary, the institutional groups of taxpayer representatives recommended the procedure embodied in the bill as part of the package solution that includes the 2-year term restriction, elimination of double counting, and approval of estate planning.

Neither the bar associations nor the AICPA is famous for implacable hostility to taxpayer interests. They sought no improved litigation opportunity recognizing that, realistically, it is an opportunity to do more. It is an opportunity to play the audit lottery, to give no notice of the too early second disposition, to contest and ultimately compromise, if but only if, an auditing revenue agent stumbles upon that second disposition and asks the right questions.

We are at one with the Treasury in concluding there has been enough of this. The bill is generous in its approach to related party installment sales. To accomplish its objective, it should have this tooth.

Mr. Chairman, we seem to be well embarked on a wonderful process. The bar association tax groups would like to express their great appreciation to the subcommittee for its willingness to consider this legislation twice, last July as H.R. 3899 in a too-narrow and too-draconian form, as the subcommittee rightly perceived, and again today when there is at hand a product of true value.

Thank you.

[The report referred to by Professor Ginsburg follows:]

JOINT REPORT: COMMITTEE ON SIMPLIFICATION, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION; COMMITTEE ON TAXATION, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK; AND TAX SECTION, NEW YORK STATE BAR ASSOCIATION

INSTALLMENT SALES REVISION ACT OF 1980

Summary

We highly commend both the process of substantive tax simplification exemplified by H.R. 6883 and the tax simplifying and reforming provisions of the bill itself. The following briefly summarizes the detailed Joint Bar Report we have submitted for inclusion in the record of this hearing.

A. Coverage of the bill

1. We approve elimination of the two payment rule.
2. We approve extension of installment treatment to sales for contingent payments.
3. We approve elimination of the 30 percent initial payment limitation.
4. We approve elimination of the current \$1,000 floor amount for qualifying installment sales of personal property.
5. We approve the automatic granting of installment treatment to all deferred payment realty sales and casual sales of personal property and the provision for a timely election out of installment treatment.
6. We approve extending installment treatment to shareholders of a corporation which, in process of liquidation under section 337, sells its assets for deferred payment obligations and distributes those obligations to the shareholders.
7. We approve the carefully tailored provisions covering the installment sale to a related party, allowing the installment method deferral but triggering the deferred gain only if and only to the extent the related purchaser voluntarily retransfers the property too early.
8. We approve the sensible extension of installment treatment to future payment obligations received incident to an otherwise tax free like-kind exchange or corporate reorganization exchange.
9. We approve the extension of section 1038 nonrecognition benefits to the repossessioning estate or beneficiary of a deceased installment seller of real property.
10. We approve the clarification of the installment obligation disposition rules as they relate to various forms of cancellation.

B. Matters focused in staff pamphlet

Properly reflecting the intent of the bill, the Staff pamphlet prepared for this hearing makes a number of clarifying points. We agree with all of them and urge that they be appropriately reflected in the Committee Report.

1. Confirmation that the ordinary farmer, who is ineligible for installment treatment under proposed section 453A, like other taxpayers similarly situated will be afforded automatic installment treatment under new section 453. This confirmation is appropriate in light of the recent decision of the Tax Court in *J. K. Griffith*, 73 T.C. No. 76 (1980).
2. Confirmation that execution of a typical close corporation shareholders agreement, by a related party installment purchaser, will not suspend the running of the normal two year safe harbor term under proposed section 453(e)(2)(B)(ii).
3. Confirmation that a related party seller can commence the running of the otherwise suspended statute of limitations by filing with the Internal Revenue Service a protective certification notice under proposed section 453(e)(8).
4. Addition of a definition of "installment obligation" in proposed section 453(f) to make it clear, for example, that a United States citizen residing abroad who sells his home or other property to a foreign purchaser for foreign currency deferred payments will be afforded installment treatment.
5. Confirmation that the new, automatic installment treatment will not adversely alter the tax treatment afforded under current law to nonresident aliens who sell property for installment payments and later take up residence in the United States.

C. Technical comments

H.R. 6883, although covering a number of related and highly technical subjects and therefore vulnerable to technical error, is extremely well drawn. We have only three technical suggestions.

1. The term "related party" is defined by reference to the section 318(a) attribution rules. Of all of the rules of this sort now extant in the Code, we find section 318(a) nearest the mark. However, we believe the definition should be refined in the single respect of excluding option attribution under section 318(a)(4). Otherwise, wholly unrelated persons who are party to a commercially normal cross-option agreement will, erroneously, be treated as related persons under the bill.

2. The concept embodied in the proposed treatment of debt boot received in an otherwise tax free like-kind exchange is exemplary, but the language employed in the bill raises a technical concern. We believe that concern can be obviated by shortening the pertinent provision, proposed section 453(f)(6), in the manner suggested in our Joint Bar Report.

3. The proposed treatment of shareholders receiving installment obligations incident to a section 337 corporate liquidation is, in general, excellent. Our only technical comment relates to the treatment of liquidating distributions received by a shareholder in two consecutive taxable years of the shareholder. To properly allocate stock basis between first and second year distributions, the bill requires that the shareholder file an amended return for year-1. An alternative course, and one we believe preferable because simplifying, is adoption of a "catch-up" approach under which the shareholder reflects all appropriate adjustments in the tax return filed for year-2.

D. Additional issues for future committee consideration

Sensibly, the bill does not attempt to resolve every anomaly in the taxation of future payment sales. In particular, and again sensibly, the bill excludes from its coverage a series of conceptually connected issues relating to payment. We believe these matters deserve separate attention, do not urge that they be treated in the pending legislation, but do recommend that on a future date the Committee re-examine and appropriately react to this area of disparate tax treatment.

Report

On March 10, 1980, Representatives Ullman, Conable, Rostenkowski, and Duncan of the House Ways and Means Committee, and Senators Long and Dole of the Senate Finance Committee, introduced through companion bills (H.R. 6883, S. 2451) the Installment Sales Revision Act of 1980, legislation to revise, reform, and simplify many of the rules governing dispositions of property for future payment. This legislation is the healthy offspring of Subcommittee hearings held last summer on a narrowly focused installment sale bill introduced May 2, 1979 (H.R. 3890, S. 1063).

We submitted to the summer 1979 hearings an extensive Joint Bar Report commending the announced congressional intention to simplify selected areas of substantive tax law and commending in particular the choice of the installment sale provision as an initial focus of this ongoing legislative project. Our 1979 report, however, criticized the earlier bill in two major respects. First, we found the treatment of related party installment sales, then proposed, to be misdirected and excessively penal. Second, we believed misguided the bill's narrow concentration on a very few specific installment sale rules. In our view sensible simplifying legislation required a broader focus, an attention to and revision of all elements that contribute importantly to the inordinate complexity of present tax law's treatment of property dispositions when payment is deferred. At the hearings the Treasury Department and the Federal Tax Division of the AICPA announced positions essentially similar.

Stimulated by the Subcommittees' response, a unique eight month collegial effort to simplify and reform this important, complex area of tax law then was undertaken. Participants included representatives of the congressional staffs, Treasury Department, bar association tax sections and the Federal Tax Division of the AICPA. Valuable comments were furnished by other concerned private sector groups. The product is the proposed Installment Sales Revision Act of 1980.

The bill comports with the recommendations unanimously made last summer, by the Treasury Department and the institutional tax groups, that Congress should react to major contributors to the field's complexity. The bill does not deal with every element in exactly the manner we recommended in our Joint Bar Report last summer, or in exactly the manner the Treasury Department or the AICPA then recommended. That would not have been possible since the various

recommendations were not identical in every detail. More importantly, in working together the participants uncovered technical problems not earlier perceived and gained appreciation of and a willingness to accommodate the special concerns of other participants. The process of identification, reasonable discourse, and fair accommodation has yielded what in our view is a signal achievement, a truly effective tax simplification and reform bill. We urge its prompt enactment.

I. The philosophy of the bill

The overarching defect in present law's treatment of sales for future payment is the lack of a unified statutory approach. Section 453, the installment sale provision allowing deferral of gain and requiring ratable recovery of basis, is unavailable if any part of the selling price is contingent in amount, if personal property is sold and the selling price is small, if the sale agreement calls for only a single payment, if the ill-advised seller fails affirmatively to elect installment treatment, or if, in the year of sale, "payment"—including an otherwise non-taxable receipt of like-kind property—exceeds 30% of the total selling price. If statutory installment treatment is unavailable or not elected, the seller in some circumstances is currently taxed on money he or she does not have, in others will avoid current gain recognition and obtain an even lengthier tax postponement under the nonstatutory method of cost recovery reporting.

Unbalanced tax consequences characterize present law beyond the election threshold. Installment treatment is available when the shareholder sells the corporation's stock; it is not available to the shareholder when the corporation sells its assets and liquidates. Gift of an installment obligation to any donee, including the maker, triggers the donor's previously deferred gain; there is authority, albeit slender, for the proposition that writing "cancelled" across the face of the note permanently avoids recognition of that gain, and at least an argument that bequest of the note to the maker achieves a similar result.

Present law's discordant taxing scheme places too great a premium on the sophistication of the accountant or lawyer. It entraps the ill-advised, usually less affluent seller while affording the wealthy and well-advised undue advantage. This reality defines the simplification objective. Both the opportunity to blunder and the opportunity of undue advantage should be circumscribed. When the commercial context calls for deferral of payment, liability to the fisc also should be deferred. When payment is in hand, an appropriate portion of the seller's gain should be recognized. The design of the transaction, straightforward and unadorned or sophisticated and byzantine, ought not mandate inappropriate acceleration or inappropriate deferral of tax.

The Installment Sales Revision Act embraces this tax simplification concept. In origin, development and coverage, the bill is commendable tax legislation.

It has been pointed out on more than one occasion that tax simplification is a very complicated business. The pending bill offers proof. Although exemplary in concept and coverage and the product of extensive effort, goodwill and accommodation, the bill in our view is incomplete or technically flawed in a very few respects. Some of these merit correction in the proposed statutory language; others we believe are better resolved through committee report clarification. The Staff pamphlet, prepared for the hearing before the Subcommittee on Select Revenue Measures, correctly identifies almost all of the latter. In the balance of this report, we first (part II) review the bill's major achievements, next (part III) summarize and support the Staff's catalog of desirable confirmations and clarifications, then (part IV) furnish our few technical comments on the bill itself, and finally (part V) suggest two additional deferred payment sale matters for future Committee consideration.

II. Coverage of the bill

The Installment Sales Revision Act of 1980 covers and sensibly resolves a host of primary and secondary simplification and reform issues that currently plague the tax treatment of future payment sales.

A. Extension of the installment sale concept

Without any justification in sensible tax policy, present section 453(b) does not provide tax deferral when the deferred payment sale fails to fit the lexicographer's notion of an installment arrangement. In the dictionary sense an installment is one of two or more payments. A sale today calling for a single full payment five years hence does not fit. The seller is denied statutory relief.¹ Had the

¹ Rev. Rul. 69-462, 1969-2 C.B. 107, amplified by Rev. Rul. 71-595, 1971-2 C.B. 223; *Baltimore Baseball Club, Inc. v. United States*, 481 F. 2d 1283 (Ct. Cl. 1973); *10-42 Corp.*, 55 T.C. 593 (1971).

seller, better advised, required and obtained a small down payment the problem would have been avoided. Further, without regard to the number of payments called for under the sale agreement, if total sale price is not fixed and determinable by the close of the sale year, so that the percentage of that total which each separate payment represents initially cannot be known, statutory relief again is unavailable.² The bill properly resolves both problems.

1. *Two Payments Rules.*—The requirement of two or more payments is eliminated.³

2. *Contingent Payments.*—The term "installment sale" is defined in the bill to encompass any property disposition in which a payment is to be received in a subsequent taxable year.⁴ New section 453 thus will encompass and afford statutory deferral of tax liability to sales and exchanges in which part or even all of the future payment obligation is contingent in amount. The ratable recovery of basis concept, central to installment reporting under the new law as now, will be extended to contingent payment transactions. As summarized by Chairman Ullman in introducing the proposed legislation:⁵

"The bill would also permit installment sale reporting for sales for a contingent selling price. Under present law, these sales are not eligible for installment reporting. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transaction. Rather, the bill provides that the specific rules will be prescribed under regulations.

"However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined in reference to the stated maximum selling price. In cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type method."

We endorse both the substantive approach to basis recovery and the decision to remit to the regulations articulation of the precise and detailed rules.⁶

B. Eligibility

A principal defect of present section 453(b) is the number and nature of substantive and practical threshold impediments to obtaining installment treatment. The two payment and fixed selling price requirements are examples. Others that deserve and receive proper attention in the bill include the 30 percent initial payment limitation, the minimum selling price requirement when personal property is sold, and the requirement that the deferred payment seller affirmatively elect installment treatment.

1. *30 Limitation.*—Whatever justifications have been advanced in its behalf, and over time they have been many and varied,⁷ the initial payment limitation has functioned in practice as little more than a trap for the unwary, an avoidable nuisance for the well-advised. The bill's elimination of the initial payment limitation strikes a major blow for tax simplification.

² This problem, a severe one when the sales agreement calls for both fixed future payments and contingent future payments, is generically known as the *Gralapp* problem. See *Gralapp v. United States*, 319 F.Supp. 265 (D.Kan. 1970), *aff'd*, 458 F.2d 1158 (10th Cir. 1972); *In re Steen*, 509 F.2d 1398 (9th Cir. 1975). But cf. *National Farmers Union Service Corp. v. United States*, 67-1 U.S.T.C. ¶ 9234 (D.Colo. 1967), *aff'd on other grounds*, 400 F.2d 483 (10th Cir. 1968).

³ Proposed § 453(b)(1).

⁴ *Ibid.*

⁵ Congressional Record, March 19, 1980, H 2004.

⁶ Statutory authority for development of the necessary or appropriate regulations is provided by proposed § 453(h).

⁷ The first statutory installment sale provision, § 212(d) of the Revenue Act of 1924, contained a 25 percent initial payment limitation justified as a means of resolving a question of valuation of the property sold on the assumption that property thereafter served as security for the debt. S. Rep. No. 52, 69th Congress, 1st session 26 (1926). In the Revenue Act of 1928 the limitation was raised to 40 percent, justified as a dividing line between cases in which the seller has and does not have "a substantial assurance of the actual payment of the full amount of the deferred purchase price." H.R. Rep. No. 2, 70th Congress, 1st session 14 (1928). The Revenue Act of 1934 introduced the 30 percent limitation and yet a different justification, the presumed ability of the seller who has received more than 30 percent to pay the entire tax. H.R. Rep. No. 704, 73d Congress, 2d session 24 (1934). Two decades later the Tax Court conjured up a fourth justification, administrative convenience. *Iran Irwin, Jr.*, 45 T.C. 544, 550 (1966), *rev'd on another point*, 390 F.2d 91 (5th Cir. 1968).

2. *Minimum Selling Price.*—Present section 453(b)(1)(B), applicable to a casual sale or other casual disposition of personal property but not to real property, denies installment treatment unless the selling price exceeds \$1,000. The bill introduced last May would have increased this floor amount to \$3,000, inappropriately burdening the small taxpayer who, rather than his wealthier neighbor, is more likely to engage in transactions of this magnitude. The new bill sensibly reverses field and eliminates the minimum sale price floor.

3. *Automatic Installment Election.*—Well-advised sellers are well aware of present law's requirement that installment treatment must be elected in the tax return filed for the year of sale. Well-advised sellers make that election when it is to their advantage. Others, less affluent and less well-advised or not professionally advised at all, too often fail timely to elect and inadvertently forego the tax referral benefit Congress has proffered. This has particularly proved the case when the sale agreement calls for no down payment. The bill advances the simplification cause in a major way by declaring installment treatment the automatic norm,⁸ allowing a timely filed election out of installment treatment⁹ to the seller who, possessing for example an expiring loss carryover,¹⁰ would be disadvantaged by deferred reporting of gain.

A nonresident alien who sells property (normally foreign situs property sold abroad) and subsequently takes up residence in the United States is, of course, not subject to federal income taxation on that transaction. Under present law this is true whether the sale is for cash or installment payments; the alien makes no present law installment election. As the Staff pamphlet notes, the statutory shift to an automatic installment election (unless the seller affirmatively elects out of installment treatment) is not intended to change this result. The Committee report, we hope, will confirm the continuation of present law's treatment of the nonresident alien.

C. Section 337 and related party sales

Present law denies a shareholder installment treatment when the corporation, adopting a plan of complete liquidation that comports with section 337, sells its property for installment notes and distributes those notes to the shareholder.¹¹ A direct sale of the corporation's shares to the same purchaser for identical notes, however, permits installment reporting. When the installment purchaser refuses to buy corporate stock, present law forcefully encourages the shareholder first to sell his stock for installment notes to a family trust or other related party intermediary; benefited by its high purchase price basis, that related buyer without tax disadvantage can cause the corporation to follow the section 337 asset sale and liquidation route.

This exercise in self-help was the origin of the so-called *Rushing* related party installment sale transaction.¹² Sophisticated taxpayers, however, quickly perceived an opportunity of special advantage. If the related buyer promptly resells for cash, the family group has received the funds but has deferred a decade or more payment of the associated tax liability. In the main, the courts have approved carefully designed schemes of this sort.¹³

The installment sale bill introduced last May did not tender an appropriate response. It condemned all related party installment sales, failing to recognize that the tax avoidance potential resides, not in that initial transaction, but rather in the early and voluntary resale for cash. More broadly, the original legislative proposal concentrated solely on tax avoidance potential and did not propose to cure, indeed would have worsened, the section 337 installment sale problem that Mr. Rushing had faced and resolved through self-help. But the two, inappropriate tax deferral when cash is in hand and inappropriate tax acceleration when cash is not in hand, are opposed faces of a single issue. The proper resolution of either requires the proper resolution of both.

⁸ Proposed § 453(a).

⁹ Proposed § 453(d).

¹⁰ See Congressional Record, March 19, 1980, H. 2004 (floor statement of Chairman Ullman).

¹¹ See, e.g., *Mercedes Frances Freeman Trust v. Commissioner*, 303 F. 2d 580 (8th Cir. 1962); *West Shore Fuel, Inc. v. United States*, 598 F. 2d 1236 (2d Cir. 1979); Rev. Rul. 73-500, 1973-2 C.B. 113.

¹² *W. B. Rushing*, 52 T.C. 888, 896 (1969), *aff'd*, 441 F. 2d 593 (5th Cir. 1971).

¹³ See *Nye v. United States*, 407 F. Supp. 1345 (M.D.N.C. 1975); *William D. Pityo*, 70 T.C. 225 (1978); *Clair E. Roberts*, 71 T.C. 311 (1978); *Earl E. Weaver*, 71 T.C. 443 (1978). Cf. *Philip W. Wren*, 67 T.C. 576 (1976); *Paul G. Lustgarten*, 71 T.C. 303 (1978); Rev. Rul. 73-157, 1973-1 C.B. 213; Rev. Rul. 73-536, 1973-2 C.B. 158; Rev. Rul. 77-414, 1977-2 C.B. 299.

The Installment Sales Revision Act comprehends this relationship and sensibly resolves both problems.

1. *Section 337.*—Subject to but a single appropriate exception, the bill declares eligible for shareholder installment treatment debt obligations issued to and distributed by a corporation incident to a section 337 liquidation.¹⁴ If the liquidating corporation has a subsidiary which also sells property and liquidates within recently enacted section 337(c)(3), debt obligations generated in that transaction qualify for installment treatment when redistributed to the parent corporation's shareholders.¹⁵ Consistent with the policy of section 337 itself, the bill provides that to qualify for shareholder installment treatment debt obligations attributable to inventory must arise from a bulk sale of the inventory of the particular trade or business.¹⁶

The bill's approach is at once consonant with the tax simplification objective and a sensible extension of the law beyond the confines of that objective. The bill simplifies in curing in a direct way Mr. Rushing's problem, equating the installment sale of a corporation's assets to the installment sale of corporate stock. The bill goes further, to the particular advantage of shareholders of closely held corporations, in allowing installment treatment when, for example, a division or the properties of a subsidiary are sold to one buyer, another division is sold to a second buyer, and a building or other investment asset is sold to a third buyer.¹⁷ In the practical world an installment sale dispersal of that sort cannot ordinarily be accomplished by selling the corporation's shares.

2. *Related Party Transactions.*—An installment sale to a related party automatically receives installment treatment. To identify and discourage tax avoidance, the bill correctly focuses on a "second disposition" by the related buyers. Reasonably balancing considerations of simplicity, equity, and revenue protection, the bill establishes these ground rules:¹⁸

If there is an inappropriate "second disposition"—in general, a voluntary and too early resale or other disposition of the property by the related buyer—the amount realized on that transaction by the related buyer (or the value of the property disposed of if the second disposition is not a sale or exchange) is treated as received at that time by the original seller.

If the property sold is other than marketable securities, a resale or other transfer by the related buyer can constitute a triggering second disposition if it is made within two years of the initial related party installment sale. If the related buyer holds subject to the normal risks of ownership for two years, the taint is off. Subsequent resale triggers no gain to the original seller. This safe harbor is eroded and the two year term extended if and while the related buyer avoids normal risks of ownership through, for example, a short sale or put or commercially equivalent arrangement.¹⁹

If the property sold to a related buyer is marketable securities, the two year safe harbor does not apply.

Without regard to the pace of events, various transactions are exempted from the triggering rule. If the property transferred in the original installment sale is corporate stock and the related buyer is the issuer, the triggering rule is inapplicable.²⁰ If either the original seller or the related purchaser dies, a subsequent transfer of the property triggers no acceleration of gain, either to the

¹⁴ Proposed § 453(g).

¹⁵ Proposed § 453(g)(1)(C).

¹⁶ Proposed § 453(g)(1)(B), cross referencing to § 337(b)(2)(B).

¹⁷ Proposed § 453(g)(1), which establishes the described rules, by disassociating (with the single exception of piecemeal sales of inventory) corporate level and shareholder level tax consequences, is excellently designed to avoid the intractable shareholder reporting and IRS audit problems that would be presented if, for example, installment reporting eligibility at the shareholder level were tied to nonrecognition at the corporate level. A separate technical problem is, however, presented by the bill's treatment of distributions received by a shareholder in more than one taxable year. Proposed § 453(g)(2). That separate technical problem and a recommended solution are discussed in part IV of this report.

¹⁸ Proposed § 453(e).

¹⁹ Proposed § 453(e)(2)(B). Although not specifically cataloged in the proposed statute, we assume that the reference there to "a short sale or any other transaction" would encompass the related buyer's borrowing (within the two years) nonrecourse against the property, at least if the amount borrowed represents a significant percentage of the property's value.

²⁰ Proposed § 453(e)(6)(A). A subsequent resale of its own shares by the issuer presents no installment sale qualification problem since, under § 1032, an issuer is not taxed on the sale of its own shares. Thus, the initial installment purchase furnished no tax avoiding basis advantage.

original seller if alive or to the estate if dead.²¹ If the related buyer's too early transfer is the product of a compulsory or involuntary conversion, section 1033, no gain is triggered to the original seller.²² Finally, if no specific exemption is available but it is established to the satisfaction of the Commissioner that neither the related party sale nor the subsequent untimely redispotion had as one of its principal purposes the avoidance of federal income tax, gain is not triggered to the original seller.²³ Thus, the statute affords a mechanism through which the special case, from illness or economic misfortune to involuntary corporate freezeout merger, may be accommodated.

Finally, if all else has failed and a second disposition is too early made, the bill affords additional measures of relief. If the related buyer sells a portion of the property to generate funds with which to make an installment payment to the original seller, there is no double counting. The actual payment absorbs the second disposition's deemed payment. If actual payment precedes second disposition, the same favorable result obtains even though the events occur in different taxable years.²⁴ And if the triggering second disposition occurs first, and no installment payment is made until a subsequent year, the earlier event in effect again absorbs the later and the original seller owes no additional tax unless and until payments received exceed the second disposition proceeds he has earlier taken into account.²⁵

D. Otherwise tax free exchangers

Under section 1031(b), when like-kind property is exchanged, gain is recognized only if and only to the extent "boot"—cash, debt obligations, and other nonqualifying property—is received. Under section 356(a)(1), in a corporate reorganization gain is recognized only if and only to the extent boot is received. Differing from the like-kind exchange, in a reorganization and recognized gain in some circumstances may be taxed as dividend income and not as the proceeds of a property disposition.

Under section 1038, an installment seller of real property, forced to repossess that property which has stood as security for the notes, recognizes gain only if and only to the extent payments previously received were offset against basis and not included in income.

When the boot received in a section 1031(b) like-kind exchange or in a section 356(a)(1) nondividend reorganization exchange is installment paper, present tax law affords senseless treatment in the former case,²⁶ uncertain treatment in the latter.²⁷ Section 1038, as it applies to realty transactions, works appropriately when the seller repossesses, uncertainly or not at all if the seller has died and the estate or beneficiary repossesses.²⁸ The bill attempts reasonable clarification and reform.

1. *Section 1031(b) Debt Boot.*—The bill appropriately provides that the term "payment" does not include qualifying (like-kind) property received. Installment obligations are not taxed in the year of receipt. In determining year of sale gain, the taxpayer's basis is first allocated to the qualifying property received up to

²¹ Proposed § 453(e)(6)(C).

²² Proposed § 453(e)(6)(B).

²³ Proposed § 453(e)(7). This provision is modeled on § 302(c)(2), which cuts off family attribution in certain corporate stock redemptions. § 302(c)(2) provides an advantageous reference. The Commissioner is generally perceived to have exercised his authority under that provision in a fair and balanced manner. See, e.g., Rev. Rul. 77-293, 1977-2 C.B. 91. Like the proposed statute, § 302(c)(2) focuses exclusively on the avoidance of federal income tax. Related party installment sales, particularly with respect to farm properties and closely held businesses, more often are motivated by considerations of estate planning than with income tax avoidance in view.

²⁴ Proposed § 453(e)(3).

²⁵ Proposed § 453(e)(5).

²⁶ Receipt of like-kind property, although otherwise nontaxable, under present law is treated as a payment with respect to the installment debt portion of the exchange consideration. See Rev. Rul. 65-155, 1965-1 C.B. 356; *Clinton H. Mitchell*, 42 T.C. 953 (1964); *C. W. Yeager*, 18 TCM 192 (1959).

²⁷ Under present law it is unclear if installment debt boot, received in exchange for shares under § 356(a)(1), may be reported on the installment method. Compare *Frances M. Avril*, 37 B.T.A. 485 (1938), *rev'd on other grounds*, 101 F. 2d 644 (1st Cir. 1938) (holding no), with LTR 7941022 (ruling 18) (holding yes).

²⁸ It is the position of the Internal Revenue Service, Rev. Rul. 69-83, 1969-1 C.B. 202, that § 1038 treatment is unavailable to a repossessioning estate or beneficiary of a deceased seller. On this theory the repossessioning successor recognizes previously deferred installment gain offset, to the extent appropriate, by the deduction afforded under § 691(c). The Service's position seems devoid of a sound basis in tax policy and has not been tested in court.

its fair market value; excess basis if any is ratably allocated to the installment debt and against any cash or other boot received.²⁹

2. *Section 356(a)(1) Debt Boot.*—The bill attends to this case in a desirably simple way, stating that rules similar to the like-kind exchange rules shall apply to an exchange which is described in section 356(a) and is not treated as a dividend.³⁰

3. *Section 1038.*—Confirming the application of section 1038 to the estate or beneficiary of a deceased seller, as the bill does,³¹ does not strictly qualify as a tax simplification measure. It does, however, provide desirable certainty where the law currently is unclear, and it does so in a manner consistent with rational tax policy. The mechanics are uncomplicated. Section 1038 encompasses the successor; in the hands of the repossessing successor the real property has an adjusted basis equal to the basis the realty would have had if the original seller were the repossessing party, increased by an amount equal to the section 691(c) deduction foregone.³²

E. Special disposition problems

The bill identifies and reacts appropriately to three avoidance cases that may inhere in present law. Each will arise, ordinarily, when buyer and seller were related.

1. *Cancellation.*—Father sells appreciated property to Daughter for a long-term installment note. Daughter enjoys the benefit of her high purchase price basis. Years later Father writes "cancelled" across the face of the note. Reversing the extraordinary result reached in one decided case,³³ the bill declares the event a disposition taxable to Father.³⁴

2. *Lapse.*—Father does not cancel the note. Instead, he takes no action to collect and, under state law and in the fullness of time, the obligation becomes unenforceable. Under the bill, Father's previously deferred gain is recognized.³⁵

3. *Bequest.*—The note is still valid and enforceable when Father dies. The note passes to Father's estate, a nontaxable disposition under section 691(a)(2). Subsequently, the estate distributes the note to Daughter, the obligor, who is an estate beneficiary. The bill amends section 691(a)(2) to make it clear that testamentary transfer to the obligor, yet another form of cancellation, is a taxable event.³⁶

III. Desirable Clarifications and Confirmations

Throughout, the Staff pamphlet properly reflects the intent of the bill. While in most respects that intent can be gleaned from the proposed statutory language, at a few points an extant court decision or simply the ambiguity of the English language renders clarification or Committee report confirmation specially desirable. Our listing of these points is presented in the order in which provisions appear in the bill.

A. Installment reporting by farmers: Proposed section 453(b)(2)

Premised on present section 453(b)(1)(B), the bill in proposed section 453(b)(2) renders automatic installment method reporting inapplicable when the personal property sold is inventory or the seller is a dealer regularly on the installment plan. Dealers in personal property are to obtain installment treatment under proposed section 453A, a re-enactment without change of present section 453(a). It is the intent of the bill that every installment seller qualify for tax deferral under either proposed section 453 (automatic installment treatment) or proposed section 453A (elective installment treatment). However, a very recent decision of the Tax Court interpreting present section 453, *J. K. Griffith*, 73 T.C. No. 76 (February 28, 1980), suggests the amazing possibility

²⁹ Proposed § 453(f)(6). Although the intended workings of the described provision are as stated, the language of the bill presents a technical problem. That problem is discussed and corrective language suggested in part IV of this report.

³⁰ Proposed § 453(f)(6).

³¹ Proposed § 1038(g).

³² The concept of treating as basis to a successor what would have been an exclusion (or deduction) to a predecessor was employed by the Tax Court in *Ridge Realization Corp.*, 45 T.C. 508 (1966) (§ 111 case).

³³ *Miller v. Urru*, 160 F. Supp. 368 (W.D.La. 1958).

³⁴ Proposed § 453(f)(1). Because buyer and seller were related, the installment obligation was treated as worth not less than its face amount. Proposed § 453B(f)(2).

³⁵ Proposed § 453B(f)(1), (2).

³⁶ § 3, Installment Sales Revision Act of 1980 (H.R. 6883, S. 2451).

that one class of taxpayers—farmers selling crops for deferred payment—may not qualify for installment method reporting under either prong of proposed new law.

Obviously this is a ridiculous result. The ordinary farmer, who is ineligible for new section 453A treatment, choosing to sell his crop for deferred payment should be afforded automatic installment treatment under proposed section 453. A committee report confirmation of congressional intent is desirable.²⁷

B. Related party sales: Proposed section 453(c)(2)(B)(ii)

When property other than marketable securities is sold to a related person for installment paper, and the buyer does not dispose of the property within two years, ordinarily a subsequent resale triggers no gain to the original seller. However, the two year period is extended if and so long as the related buyer's risk of loss with respect to the property is substantially diminished. Proposed section 453(c)(2)(B)(ii) defines that concept to include "the holding by another person of a right to acquire the property."

We believe the quoted provision will perform an important protective function (e.g., related buyer promptly leases the property to a third party for a two year term, granting the third party an option to purchase at the end of that term). But, with the Staff, we urge Committee report confirmation that the quoted provision will not encompass a typical close corporation shareholders agreement.²⁸

C. Related party sales: Proposed section 453(e)(8).

Adopting an approach derived from section 302(c)(2), the bill protects the fisc from an untimely but unannounced second disposition by holding open the statute of limitations. For the original seller's taxable year in which the second disposition occurs, the period for assessing a deficiency will not expire (but only with respect to deferred installment gain) until two years after the date on which the original seller certifies to the Internal Revenue Service that "there was a second disposition of the property to which this subsection [§ 453(e)] applied."

It is in the interests of the taxpayer, and of the Internal Revenue Service as well, that there be an end to things. If the related buyer has made an early retransfer and the original seller believes there was no tax avoidance in the first sale or the second, the original seller ought to be able to assert that position to the Service and commence the running of the statute of limitations. But the language of proposed section 453(e)(8) does not inevitably fit the notion of a protective certification. We recommend that an appropriate endorsement of the "protective certificate" be included in the committee report.

D. Definition of "installment obligation": Proposed section 453(f).

The bill defines the term "installment method" and uses at a number of places, but does not define, the term "installment obligation." For the reasons suggested by the Staff and summarized below, we think it desirable, while not essential, that a definition of "installment obligation," substantially to the following effect, be inserted as an additional paragraph in proposed section 453(f):

() Installment obligation.—The term "installment obligation" means any obligation of future payment, whether fixed or contingent in amount and whether dischargeable in money or other property, issued in connection with a disposition of property by the person to whom such disposition is made.

Insertion of the definition seems to us useful for various reasons. First, it furnishes early and explicit confirmation that new section 453's installment method encompasses obligations contingent in amount; as drafted the bill's explicit reference to arrangements of this sort is isolated in proposed section 453(h)(2) which authorizes promulgation of regulations. Second, definitional reference to "any obligation of future payment" properly encompasses the enforceable oral promise, a confirmation we think desirable. Third, definitional reference to an obligation "whether dischargeable in money or other property" ap-

²⁷ The installment seller of real property presents a distinguishable case. Whether the real property seller is a casual seller or a dealer he has long been treated as falling under present § 453(b) and not under present § 453(a). Consistently, the realty seller should be governed by proposed § 453 and thereby afforded automatic installment treatment. We recommend that the committee report contain a statement confirming this conclusion.

²⁸ There is ample precedent in the tax law for affording protective treatment to shareholders agreements and analogous arrangements. See Treas. Reg. § 1.691(a)-2(b), Example (4).

propriately clarifies what has been uncertain under present law. For example, a United States citizen residing abroad may there sell his home or other property for future payments in local currency; for United States tax purposes foreign currency is property, not money, and it is today at best unclear whether the described transaction may be reported on the installment method. As another example, a taxpayer may exchange investment property for property of like-kind to be identified and transferred to him over a period of more than one year, any balance of value to be paid in cash at a future date;³⁰ the definitional provision should aid in the drafting of regulations appropriate to this case.

IV. Technical comments

Attesting to the care with which it was formulated, the Installment Sales Revision Act raises remarkably few technical concerns. Our three technical comments are presented in the order in which provisions appear in the bill.

A. Related person: Proposed section 453(f)(1)

The bill defines related person to mean "a person whose stock would be attributed under section 318(a) to the person first disposing of the property." Of the attribution and relationship rules now in the Code, we find section 318(a) nearest the mark.³¹

There is, however, one problem that deserves statutory attention. Assume A and B, unrelated individuals, are the stockholders of a corporation or the common owners of a parcel of real property. They are parties to a cross-option agreement under which either has a right to purchase the other's interest. If, pursuant to option exercise or separate negotiation, A sells to B for installment notes, B's subsequent dealings with the property should not affect A's right to defer recognition of gain until payment to him is made.

Under the option attribution rule of section 318(a)(4), however, B appears to be a "related person" for purposes of new section 453. This characterization produces an untenable result. To reverse that result, we urge that proposed section 453(f)(1) be amended to read as follows (inserted language in *italics*):

"(1) Related person.—The term "related person" means a person whose stock would be attributed under section 318(a) (*other than paragraph (4) thereof*) to the person first disposing of the property."

B. Like-kind exchanges: Proposed section 453(f)(6)

The concept embodied in this provision of the bill is exemplary, but the language employed raises a technical concern.³² While the now proposed language may be retained if the committee report furnishes creative clarification of a rather high order, we recommend as a better course revision of proposed section 453(f)(6) along the following lines:

(6) Like-kind exchanges, etc.—In the case of any exchange described in section 1031(b) or in section 356(a)(1) and not treated as a dividend, the term "payment" does not include any property permitted to be received in such exchange without the recognition of gain.

We suggest the committee report confirm that, in determining year-of-exchange gain recognized and the basis, if any, at which the taxpayer will hold installment obligations received in the exchange, basis shall be allocated first to non-recognition property (but not in excess of the fair market value thereof) and remaining basis, if any, shall be allocated to installment obligations and any cash or other payments received in accordance with the regulations to be prescribed under new section 453(h).

³⁰ See *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).

³¹ Like all of the other attribution and relationship provisions now in the Code, § 318(a) is hardly without problems. Nonetheless, § 318(a) seems the best choice for the new installment sale statute because it encompasses cases that should be covered (e.g., sale to a trust that was established by the seller's parent for the benefit of the seller's children), omits cases that should not be covered (e.g., sale to a brother or sister or to a spouse of a parent or child of the seller), and presents difficulties of a sort that can be managed in the regulations (e.g., attribution to and from a trust when the beneficiary's interest is subject to a spray power or is a contingent remainder).

³² As an instance, proposed § 453(f)(6)(B) reduces gross profit "by the amount of gain not recognized by reason of section 1031(b)." § 1031(b) keys to, among other things, the fair market value of property (including debt obligations) received. Under both present and proposed § 453, however, the fair market value of an installment obligation is wholly irrelevant; proposed § 453 keys exclusively to face amount when the installment obligation is in a fixed sum, and concentrates solely on concepts of basis recovery when the installment obligation is contingent in amount.

C. Section 337 transactions; Proposed section 453(g)(2)

Example. Mr. A owns all of the stock of X corporation at an adjusted basis of \$300,000. He is on the calendar year. X owns two investment properties. On July 1, 1980 X adopts a plan of complete liquidation (comporting with section 337), promptly sells one investment property for \$400,000 cash, and immediately distributes the cash to A. On February 1, 1981 X sells its other property for \$600,000 in long term installment notes (bearing adequate interest) and distributes the notes to A in completion of its liquidation.

Under present law and under the bill, in 1980 (year-1) A offsets his entire \$300,000 basis in the X shares against the \$400,000 cash distributed to him in that year. He thus reports 1980 capital gain of \$100,000. Receipt of \$600,000 of installment notes in 1981 (year-2), however, requires an adjustment. The informing notion is this: Had A received the total distribution of cash and notes in a single taxable year he would have been required ratably to allocate his \$300,000 basis 40 percent (\$120,000) to the cash and 60 percent (\$180,000) to the notes and thus would have been required to recognize immediate gain of \$280,000 (cash of \$400,000 less \$120,000 basis allocated to the cash). Since A recouped his entire \$300,000 basis in year-1 and recognized in that year only \$100,000 of gain, he now is obligated to recognize an additional \$180,000 of capital gain and will hold the installment notes at a basis of \$180,000.

The single issue is one of timing. Is A to recognize the additional \$180,000 gain in year-2 (1981), the year in which the liquidation is completed and all facts are known (a catch-up approach)? Or is A to recognize the additional gain in year-1 (1980), the year in which the excess cash was in fact received, in which event A must be required to file an amended return for that taxable year?⁴²

The bill's proposed section 453(g)(2) adopts the amended return approach. This is a "pure" solution in that it essentially deprives Mr. A of the financial advantage inherent in even a one year postponement of gain recognition. It is, nonetheless, a troubling solution in that it produces one of the very rare cases in which the tax law requires the filing of an amended return to change prior year reporting to reflect events occurring after the close of that prior year.⁴³

The catch-up approach, under which Mr. A would first calculate his year-2 tax results as if all distributions were made in that year and then would subtract the gain recognized and reported in year-1, lacks the conceptual purity of the amended return solution. But it is, in our view, a simpler and thus a preferable solution. The X corporation of the example may be widely held and Mr. A's basis \$300, no \$300,000, his proceeds \$400 cash and \$600 notes, not \$1 million. This Mr. A has difficulty enough filing one tax return each year. He is unlikely to view an amended return directive as the triumph of tax simplification.

While we believe the catch-up solution preferable, we are not militant in our objection to the bill's amended return requirement. It is our understanding that the Federal Tax Division of the AICPA and the Treasury Department currently view the matter as we do, preferring the catch-up solution but quite prepared to follow the amended return route should Congress find that "pure" solution the better solution.

If, however, our recommendation in favor of catch-up is adopted, proposed section 453(g)(2) must be redrafted. We suggest the following language (new material in *italics*):

(2) Distributions received in more than 1 taxable year of shareholder.—If—

(A) paragraph (1) applies with respect to any installment obligation received by a shareholder from a corporation, and

(B) by reason of the liquidation such shareholder or his successor receives property in more than 1 taxable year,

then, on completion of the liquidation, basis previously allocated to property so received shall be reallocated between such taxable years so that the shareholder's basis in the stock of the corporation is properly allocated among all property received in such liquidation by such shareholder or any successor. If

⁴² In the example case all cash was received in year-1 and thus all immediately recognizable gain can be attributed to that year. There can of course be cases in which cash is received in both taxable years in which event gain may be attributed to each, and cases in which the installment notes are distributed in year-1 and the cash is distributed in year-2. The latter case presents no amended return problem, and the former is analytically indistinguishable from the example case.

⁴³ Other cases are exemplified by the failure timely to reinvest in a new principal residence the proceeds of sale of a prior principal residence. See § 1034(j).

by reason of such reallocation recognized gain, in excess of gain previously recognized, shall be attributable to an earlier taxable year, such additional gain shall be treated as recognized at the time such liquidation is completed.⁴⁴

V. Additional issues for future committee consideration

Sensibly, the bill does not attempt to resolve every anomaly in the taxation of future payment sales. In particular, and again sensibly, the bill excludes from its coverage a series of conceptually connected issues relating to payment. We believe these matters deserve separate attention, do not urge that they be treated in the pending legislation, but do recommend that on a future date the Committee re-examine and appropriately react to this area of disparate tax treatment.

A. Payment

A very recent decision of the Tax Court, *J. K. Griffith*,⁴⁵ and an even more recent decision of the Fifth Circuit, *Watson v. Commissioner*,⁴⁶ newly raise a concern that matured subsequent to the setting of the bill's coverage. *Griffith* and *Watson* further supports the conclusion, that under current law a farmer selling a crop for a deferred payment obligation secured by a standby letter of credit cannot report the transaction on the installment method. This result was reached even though the standby letter of credit in issue was specifically made nonassignable and nontransferable, and even though the farmer did not have recourse to the standby letter of credit in the year of sale. We think this result inappropriate, contrary to what had been understood to be the law in the installment sale area, and a trap for the unwary.

B. Collection gain

The character of collection gain in a qualifying installment sale is determined by the character and holding period of the property sold. This is appropriate. However, outside the installment sale area, it is an unfortunate anomaly of current law that collection gain can qualify as long-term capital gain if the obligor is a corporation or governmental entity, but cannot qualify for capital gain treatment if the obligor is neither.⁴⁷ The divergent tax treatment is senseless. A seller's tax ought not depend upon the identity of an unrelated buyer. At the hearings held last summer it was the generally expressed view that this anomaly in present law ought to be expunged. But, the problem arising only outside the installment sale arena, it is one to be resolved on another day.

V. Conclusion

The proposed Installment Sales Revision Act of 1980 is commendable tax legislation. Its few desirable confirmations and even fewer technical problems seem to us easily comprehended and almost as easily resolved by amendment or committee report clarification.

It is our earnest hope that Congress will move swiftly to enact this bill, and the bill's adoption and the careful collegial process through which it was formulated will furnish the encouragement and the blueprint for future legislation designed to simplify and improve our inordinately complex tax law.

STATEMENT OF HERBERT J. LERNER, CHAIRMAN, TAX ACCOUNTING SUBCOMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LERNER. My name is Herbert J. Lerner. I appear today on behalf of the American Institute of CPA's in my capacity as chairman of the Tax Accounting Subcommittee of the Federal Tax Division of that organization. My professional address is 1225 Connecticut Avenue, Northwest, here in Washington.

⁴⁴ The inserted references to the shareholder's "successor" are to take account of the case, for example, in which the shareholder dies after the first liquidating distribution and before the second.

⁴⁵ 73 T.C. No. (1980). See also *Sprague v. United States*, 78-2 U.S.T.C. ¶ 9650 (W.D. Okla. 1978).

⁴⁶ Decided by the Fifth Circuit March 14, 1980 (not a § 453 case).

⁴⁷ See § 1232(a).

The AICPA is particularly please to have this opportunity to testify on H.R. 6883, a bill to amend the Internal Revenue Code to simplify and revise the rules concerning the installment method of reporting gain from sales of real property and casual sales of personal property.

We have submitted a detailed statement for the record, which I ask be accepted at this time, but I would like to summarize some of our views in that.

Mr. ROSTENKOWSKI. Your statement will be included in the record.

Mr. LERNER. As previously has been indicated, this bill is really an outgrowth of the hearings on the proposal last year upon which we had the privilege of commenting as well as subsequent consideration in which we participated with representatives of several bar association groups, the Treasury Department and congressional staff personnel.

We firmly believe that this distillation process has resulted in an introduced bill which we believe will be truly responsive to the need for simplification in this important area. In addition to simplifying a number of unnecessarily complicated and troublesome aspects of current law, the bill also eliminates the prospect for continued abusive use of installment sales involving related parties and makes other desirable, substantive changes.

This has been an unusual process of concerted effort on the part of these groups. We are especially pleased to have been a part of that. As a personal matter, I have found this to be as professionally satisfying as any other activity that I have been involved with.

I think that, as a result of that concerted effort, we have had good input in developing tax policy. We have had a cooperative effort on the part of all of these parties, and I think the resulting product is exceptional as a result of that effort. We look forward as an institution to the opportunity to participate in other simplification efforts along these same lines.

Having said that, there is a little doubt that we can firmly state that we wholeheartedly support the prompt enactment of H.R. 6883. There are a few points in connection with that bill that we would like to present comments on here but I think it is also fair to say that some or many of the provisions in H.R. 6883 reflect previous legislative recommendations that our organization has presented to the Congress.

It reflects four or five specific legislative recommendations which are keyed primarily to simplification previously made by our division and reflected in our recommended tax law changes booklet which has been submitted to this committee. Most of these have been recounted in somewhat greater detail by Mr. Ginsburg, and I will refer to them briefly.

We have supported and believe it is essential to simplification in this area that single-payment deferred sales will qualify for installment treatment. The elimination of the 30-percent rule makes eminent sense to us. Permitting installment reporting on contingent and open-ended sales should eliminate many controversies under existing laws and will provide a tax policy which reflects an ability to make that concept consistent with the overall treatment of installment reporting.

We agree with the approach of leaving to regulations the formulation of precise details about how a ratable basis for contingent payment sales will work. However, we urge that appropriate examples

be included in the committee report to provide guidance to taxpayers until regulations are promulgated.

We also find comfort in the fact that the bill proposes to permit installment reporting for installment obligations received in the section 337 liquidation. The denial of installment sale treatment under present law in that context doesn't make any sense to us.

While that recommendation of the Federal tax division for permissible use of the installment treatment under section 37 liquidation where installment obligations were distributed was based on ability-to-pay considerations, we also think it will go a long way in furthering simplification by eliminating the need for engaging in transactions such as described in the *Rushing* case.

In addition to eliminating those problems and providing those areas of simplification that we have previously suggested, we have been supportive of the elimination of the \$1,000 sales price floor for qualification; and we have supported, as previously indicated, the substantive restriction on related party sales.

We have also supported the extension of the installment treatment to future payment obligations received in like-kind exchanges and in corporate reorganizations. We support both of those provisions on ability-to-pay grounds.

The provision on the automatic election of installment reporting, we think, ultimately will achieve a desirable form of simplification. Assuming that a given transaction may properly qualify for recovery-of-cost treatment under existing law, we believe that it is appropriate that, under the election-out procedure, that Service be put on notice of that fact through that procedure.

A few of the technical recommendations that we have concerning the bill really are few in number because of the distillation process in the drafting. We have indicated three of those in terms of technical recommendations and several in terms of recommendations that we believe would be appropriate to include in the committee reports.

Our technical recommendations include a clearer description of the party to make the election, to make the notification with respect to the second disposition in implementing proposed section 453(d)(8).

With respect to the related person, as described by Mr. Ginsburg, we strongly support the exclusion of option attrition to make that a more workable provision.

With respect to the 337-453 interplay, our recommendation is that the effective date of that provision be amended to take into account only distributions of installment obligations occurring after the date of enactment.

Because of potential uncertainties concerning when a plan of liquidation is adopted, revoked or abandoned, perhaps whether a new plan is adopted, the effective date of proposed section 453(g) may invite controversy with respect to closely held corporations. We would urge that it be keyed to the distribution date.

As far as committee report clarification, we have relatively few comments because of the excellent work that has gone into this. However, I would like to point out just a few of those.

On the election out of the installment method, under the installment sales rules, gains from deferred payment sales of property by an alien is not subject to tax. We think it is important that that provision be

reflected in the committee report as has been indicated in the staff report.

In a similar vein, we request that the committee report make it clear that an exempt organization does not have to make an affirmed election out of the installment sales treatment in the year of deferred payment sale to protect itself against taxability of future payments should it subsequently lose its exemption.

If an election out has to be made affirmatively in these types of cases—and there may be others—this would create a trap for a different group of unwary taxpayers. We feel that this is not an intended result, so it seems appropriate to us to have the election-out procedure applicable in any case where not to do so would provide such unintended detriment to the taxpayer.

We support extending the 2-year period for resales by related party purchasers if and when the related buyer's loss with respect to the property is diminished substantially. We urge that the committee report make it clear that options granted to acquire the property do not extend the 2-year period unless the risk of loss truly is diminished. It is under only those circumstances that it seems appropriate to extend that period.

Similarly we strongly urge that the committee report make it clear that related parties are determined only by reference to a statutory provision under section 318(a). We acknowledge that the Service can and should properly attack a sham transaction at any time. We feel strongly that there should be no implication of the committee report that sales between relatives not included within the purview of section 318(a) are any more susceptible to abuse than other sales. If this implication is present, then the bill will not have achieved the level of clarity that certainly it was intended to achieve.

We also urge that the committee report make it clear that an income basis for a basis of recovery would be appropriate with respect to sales of property such as motion pictures or minerals. We also urge that early consideration be given to the Federal tax division recommendation which we submitted in our detailed statement concerning changes from the accrual to the installment method of reporting sales of property by dealers. We believe that this represents a noncontroversial related problem area that calls for prompt consideration.

Mr. Chairman, I appreciate the opportunity of presenting the views of the AICPA on the subject and we would be pleased to participate in the process like this in the future as we believe this is the correct way to proceed in this area.

[The prepared statement follows:]

STATEMENT OF HERBERT J. LERNER, CPA—CHAIRMAN, TAX ACCOUNTING SUBCOMMITTEE OF THE FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The Federal Tax Division of the American Institute of Certified Public Accountants is pleased to have the opportunity to submit this statement and offer testimony on H.R. 6883, the bill introduced and co-sponsored by Chairman Ullman, and Representatives Conable, Rostenkowski, and Duncan to amend § 453(b) of the Internal Revenue Code of 1954 to simplify and revise the tax rules for reporting the gain under the installment method for sales of real property and casual sales of personal property. This bill is an outgrowth of the hearing on a proposal last year (H.R. 3899), upon which we had the privilege of commenting, as well

as subsequent consideration in which we participated with representatives of several organized bar groups, the Treasury Department and congressional staff personnel. This distillation process has resulted in an introduced bill which we believe will be truly responsive to the need for simplification in this important area. In addition to simplifying a number of unnecessarily complicated and troublesome aspects of current law (commented upon below), the bill also eliminates the prospect for continued abusive use of installment sales involving related parties and makes other desirable substantive changes.

In short, we wholeheartedly support the prompt enactment of H.R. 6883 in its present form. Set forth below are our detailed comments as well as other suggestions for future changes in the overall area of installment sale reporting.

Simplifying changes under § 453(b)

H.R. 6883 reflects four (of the five) specific legislative recommendations previously made by the Federal Tax Division and contained in our "Recommended Tax Law Changes" booklet:

(1) *Single deferred payment sales would qualify for installment treatment.*—Whereas under current law, the Internal Revenue Service has ruled¹ (and courts have agreed²) that a taxpayer may not elect to report income from the sale of real property on the installment method where the total purchase price is payable as a single sum in a year subsequent to the year of sale, the bill would eliminate the requirement that a sale agreement must provide for two or more payments to qualify for installment reporting.

(2) *Elimination of the 30-percent rule.*—The bill would eliminate the 30-percent initial payment limitation for reporting gain on the installment method from the disposition of real property or a casual sale of personal property by a nondealer. We believe that elimination of the 30-percent limitation will remove a trap for the unwary taxpayer and thus result in simplification. In addition, it will obviate the need for arranging transactions in less than their most desirable form from a business standpoint simply to satisfy an arbitrary limitation.

(3) *Installment reporting should be permitted in contingent or open-end sales.*—Under current law, it has been held that to qualify for installment sale reporting, a fixed and determinable selling price must exist at the time of the sale.³ The bill will change their result and permit installment sales reporting for a sale which includes a contingent element for all or part of the contract price.

We strongly support this desirable change. We feel that it will not only provide sellers an opportunity to consummate such sales with assurance about the resulting tax treatment, but will also eliminate much of the controversy that arises from the alternative use of the "deferred payment method" of reporting.

We agree with the approach of leaving to regulations the formulation of the precise details of how ratable basis recovery for contingent payment sales will work; however, we do urge that appropriate examples be included in the Committee Report to provide guidance to taxpayers until regulations are promulgated.

(4) *Installment reporting should be permitted for installment obligations received in a § 337 liquidation.*—Under present law, a shareholder is denied installment sale treatment when the corporation adopts a plan of complete liquidation under § 337, sells its property for installment notes, and distributes those notes to the shareholders. While a special rule generally protects the corporation from gain recognition upon the distribution of the installment obligations, the shareholders have to take the fair market value of those notes into account for determining currently taxable gain on the liquidation.

The bill will permit the deferral of gain recognition when a shareholder receives installment obligations in liquidation of the corporation which were received by the corporation from a sale of its assets during the twelve-month liquidation period. The shareholder may report gain from the liquidation on the installment method as payments are received on the installment obligations. Installment obligations attributable to the sale of inventory by the liquidating corporation would not be eligible for this treatment unless they are the result of a bulk-sale of the inventory of a particular trade or business.

¹ Revised Ruling 69-402, 1969-2 CB 103, amplified by Revised Ruling 71-595, 1971-2 CB 223.

² *Baltimore Baseball Club, Inc. v. United States*, 481 F. 2d 1283 (Ct. Cl. 1973); 10-42 Corp., 55 TC 593 (1971).

³ See, e.g., *Gralapp v. United States*, 458 F. 2d 1158 (10th Cir. 1972); and *In re Steen*, 509 F. 2d 1398 (9th Cir. 1975).

While this recommendation of the Federal Tax Division was based primarily on tax equity and ability-to-pay considerations, it definitely has a simplification aspect. Permitting the shareholder-recipient of an installment obligation to report his liquidation gain attributable to such obligation under the installment method alleviates the need for the use of a related-party sale of stock on the installment basis as was used in *Rushing*.⁴

The bill deals with the problem of liquidating distributions received in two taxable years by requiring an amended return for the first year. We support that approach, although we would prefer a "catch-up" rule, if a simple one could be developed. We realize that a catch-up provision which takes into account the difference in marginal tax rates between years and the value of a one year deferral of tax liability probably would be complex both from a statutory drafting standpoint and from a taxpayer computation standpoint.

We do have one technical recommendation concerning the effective date of this provision of the bill. (See technical recommendations that follow.)

In addition to the foregoing simplifying changes, the bill also would:

- (1) *Eliminate the \$1,000 sales-price floor for qualification for installment reporting of casual sales of personal property.*—In our previous testimony before this Subcommittee on H.R. 3899, we suggested that simplification would be better served by eliminating the \$1,000 threshold amount. We are pleased to see that the current bill has taken that approach.

- (2) *Restrict related-party sales.*—The bill takes what we consider to be a very reasonable approach to dealing with "Rushing-type"⁵ sales whereby gain is deferred by the initial seller and the property is soon thereafter sold by the related purchaser so that the related group, considered as one economic unit, has cash in hand as well as deferral of the gain. Rather than prohibiting outright installment reporting for related-party sales, the bill causes an acceleration of income to the original seller when, and if, the related-party buyer makes a disposition of the property too soon after its purchase.

In applying the new related-party rules, the bill uses the attribution rules of § 318(a). This accords with our recommendation made during testimony before this Subcommittee on H.R. 3899. However, we do have one technical recommendation (discussed later) concerning the application of these rules.

Under the bill, when there is a second disposition of property sold to a related-party purchaser, the amount realized on that disposition by the related buyer (or the fair market value of the property disposed of if the second disposition is not a sale or exchange) is treated as received at that time by the initial seller, but only to the extent that it exceeds actual payments made under the installment sale before the end of the taxable year. In addition, if a second disposition results in the recognition of gain to the original seller under the bill, subsequent payments to the seller would be recovered tax free until they equal the amount realized from the disposition which results in acceleration of gain recognition.

In the case of property other than marketable securities, the resale rule generally would apply only for dispositions occurring within two years of the initial sale. However, the running of the two-year period is suspended if, and while, the related buyer's risk of loss with respect to the property is substantially diminished through a short sale, a put, or the granting of an option to acquire the property. (See our comments concerning desirable Committee Report clarification of the option rule.)

If the property sold to the related buyer is marketable securities, the two-year resale rule does not apply. Instead, gain recognition can be accelerated if there is a second disposition at any time before the installment obligation is satisfied. (See our comments concerning desirable Committee Report clarification of the definition of "marketable securities.")

The bill provides several desirable exceptions to the application of the related-party rules. First, the bill exempts any sales of stock to the issuing corporation from the related-party rules altogether. This is in recognition of the fact that there is no abuse potential if a corporation acquires its stock from a shareholder

⁴ *Rushing v. Commissioner*, 441 F. 2d 593 (5th Cir. 1971) aff'g 52 TC 888 (1969).

⁵ Footnote 4, supra. While *Rushing* did not involve an immediate sale for cash outside of the related group (the corporation adopted a plan of liquidation and sold its assets to an unrelated buyer for notes and cash before *Rushing* sold his stock to the trust for his children, and then liquidated by distributing the buyer's notes to the trust), subsequent cases have involved immediate sales for cash to unrelated third parties or sales of corporate assets for cash followed immediately by liquidation of the corporation. See for example, *William D. Pityo*, 70 TC 225 (1978); *Clair E. Roberts*, 71 TC 311 (1978); and *Carl E. Weaver*, 71 TC 443 (1978).

and then resells it, since there is no gain from the sale of a corporation's treasury stock in any event, and therefore the related party group does not benefit from a step-up in basis from the original transaction. Second, the bill excepts from the early disposition triggering rules any disposition by the related-party purchaser that arises from a compulsory or involuntary conversion so long as the initial sale occurred before the threat or imminence of the conversion. Third, if either the original seller or the related purchaser dies, a subsequent disposition of the property is not subject to the early disposition triggering rules. Finally, if it is established to the satisfaction of the Commissioner that neither the original sale nor the early disposition by the related party had as one of its principal purposes the avoidance of Federal income tax, gain is not triggered to the original seller upon the second disposition. The staff pamphlet notes that this mechanism may be utilized to permit certain tax-free transfers of the purchased property, e.g., charitable contributions or gifts, not to be treated as early dispositions.

To protect the interests of the Treasury, under the bill, the period for assessing a deficiency in tax attributable to a disposition by the related-party purchaser will not expire before the day which is two years after the date the original seller furnishes a certificate that there was a second disposition of the property. The certificate is to be furnished in the manner prescribed by regulations. We support this rule as being necessary; however, we do have technical comments concerning its application.

We strongly support the bill's approach to dealing with potential abuses resulting from related-party installment sales, which at the same time permitting a great many nontax-motivated sales to be consummated.

(3) *Extend installment treatment to future payment obligations received in like-kind exchanges or corporate reorganizations.*—The bill provides that the receipt of like-kind property will not be taken into account in determining gain recognized for installment sale reporting purposes. In addition, the bill provides that rules similar to the like-kind exchange rules will apply to an exchange which is described in § 356(a) and is not treated as a dividend.

We support both of these proposed changes on ability-to-pay grounds.

(4) *Permit § 1038 treatment to estate of a deceased taxpayer who sold real property on the installment method.*—The bill provides that an executor or beneficiary who receives an installment obligation from a decedent will succeed the decedent for purposes of qualifying for nonrecognition treatment if the property is reacquired in satisfaction of the obligation. Under present law, the Internal Revenue Service has ruled that § 1038 does not apply to a reconveyance to the estate of a deceased taxpayer who made the original sale.*

We support this change because it provides certainty and because we believe it reflects sound tax policy.

(5) *Deal with special disposition problems.*—The bill would make it clear that the cancellation of an installment obligation or permitting it to become unenforceable because of lapse of time will be treated as a disposition of the obligation which will trigger deferred gain to the holder. If the holder and the obligor are related parties, the fair market value of the obligation will be treated as not less than face value.

The bill also provides that the installment obligation disposition rules cannot be avoided by bequeathing the obligation to the obligor. The bill amends § 691(a)(2) to make it clear that a testamentary transfer to the obligor is a taxable event.

We support these changes from a tax-equity standpoint and because we believe they reflect sound tax policy.

(6) *Automatic election of installment reporting.*—A further simplification of our tax law would occur by virtue of the automatic election of installment reporting provided by the bill. By making installment treatment the norm with an election out of installment treatment when that would be desirable, e.g., where the seller has an expiring net operating loss, the bill removes a trap for the unwary taxpayer who will no longer be hurt by an error of omission.

Under the bill, generally, an election not to have installment sale reporting apply to a deferred payment sale must be made in the manner to be prescribed by regulations on or before the due date (including extensions of time for filing) for filing the income tax return for the year in which the sale occurs. However, late elections may be allowed pursuant to regulations. It is our hope that these regula-

* Revised Ruling 69-83, 1969-1 CB 202.

tions will permit late elections when reasonable cause exists for the failure to make a timely election-out.

Once an election out of installment sales treatment is made, it generally will be irrevocable. However, the Secretary is given the authority to consent to a revocation. We hope that consent to a revocation will be permitted when it does not have as one of its principal purposes the avoidance of income taxes.

We feel that the election out procedure provides an appropriate limitation on the use of cost recovery reporting and will also put the Service on notice that such reporting method is being used. Assuming that a given transaction may properly qualify for recovery of cost under existing law, we believe it is appropriate that the Service be put on notice of that fact through the election-out procedure.

Technical recommendations concerning the bill

Due to excellent drafting and the distillation process through which the bill was put, we find very few technical problems in the language of the bill. Our three technical comments are presented in the order in which the provisions appear in the bill.

1. *Extension of statute of limitations—Proposed section 453(c)(8).*—The bill provides that "The period for assessing a deficiency with respect to a disposition * * * shall not expire before the day which is 2 years after the date on which the persons making such disposition furnishes * * * a certificate that there was a second disposition of the property * * *."

Presumably the party that is responsible for filing the certification as to a second disposition is the initial seller and not the related-party purchaser. Although this could be made clear in the Committee Report, it would appear preferable to make this clear in the statute. It appears that this could be done simply enough by substituting the words "the first" in place of the word "such" immediately preceding the word "disposition" in line six of proposed § 453(c)(8).

2. *Related person—Proposed section 453(f)(1).*—While we concur with defining related persons by reference to the attribution rules of § 318(a), we do not feel that otherwise unrelated persons should be deemed related because of the option attribution rule of § 318(a)(4). Therefore, we urge that proposed § 453(f)(1) be amended by inserting "(other than paragraph (4) thereof)" immediately after "§ 318(a)" where it appears in that section.

3. *Section 5(a)(3) of the bill.*—This section provides that proposed § 453(g), relating to the use of the installment method by shareholders in § 337 liquidations, would apply to plans of liquidation adopted after the date of the bill's enactment. We would urge that § 453(g) be applicable to distributions of installment obligations occurring after date of enactment. Recipients of such installment obligations who desire the tax treatment of present law could elect out of installment treatment.

Because of potential uncertainties concerning when a plan of liquidation is adopted, revoked or abandoned, and perhaps whether a new plan is adopted, the effective date of proposed § 453(g) may invite unnecessary controversy for affected taxpayers of a closely-held corporation. This problem may be more important, in light of the March 31, 1980, effective date for the related-party sale rules.

Suggestions for committee report clarification

In most respects, the meaning of the bill's language is very clear. However, there are a few points we feel that the Committee Report should expand upon. Our listing of these points is presented in the order in which they appear in the bill.

1. *Election out of installment method—Proposed section 453(d).*—Under the installment sale rules of present law, gains from deferred payment sales of property by a nonresident alien do not become taxable as payments are received after the seller becomes a resident or citizen subject to U.S. income tax for a year subsequent to the year of sale. We suggest that the Committee Report make it clear that this rule is to continue under the election-out procedure.

In a similar vein, we request that the Committee Report make it clear that an exempt organization does not have to make an affirmative election out of installment sale treatment in the year of a deferred payment sale to protect itself against taxability of future payments should it subsequently lose its exemption.

If an election out must be made affirmatively in the foregoing cases, this will create a trap for a different group of unwary taxpayers. We feel sure that this would not be intended.

2. *Related party sales—Proposed section 453(e)(2)(B).*—While we support extending the two-year period for resales by a related-party purchaser if, and while, the related buyer's risk of loss with respect to the property is diminished substantially, we urge that the Committee Report make it clear that options granted to acquire the property do not extend the two-year period unless the risk of loss truly is diminished. For example, if a related-party purchaser leases the property to a third party for a two-year term, granting the third party an option to purchase at the end of the term at the then fair market value, there would seem to be no diminishing of risk of loss; therefore, the two-year period should not be extended. However, if a portion, or all of the "lease" payments may be applied against the purchase price, risk of loss probably has been reduced and the two-year period should be extended (assuming that such transaction is not treated as a sale from its inception).

Proposed § 453(e)(2)(B)(iii) extends the two-year period when there is a short sale or "any other transaction." It would be helpful if the Committee Report could furnish some examples of what would be included in that category. One example of "any other transaction" possibly could be the immediate securing of a nonrecourse loan by the purchaser.

3. *Related person—Proposed section 453(f)(1).*—We strongly urge that the Committee Report make it clear that related persons are determined only by reference to § 318(a). While we acknowledge that the Service can attack a sham transaction at any time, we feel strongly that there should be implication in the Committee Report that sales between relatives not included within the purview of § 318(a) are any more susceptible to abuse than other sales. If this implication is present, then the bill will not have achieved the level of clarity and certainty that it was intended to achieve.

4. *Marketable securities—Property section 453(f)(2).*—Proposed § 453(f)(2) defines the term "marketable securities" as "• • • any security for which, as of the date of the disposition, there was a market in an established securities market, or otherwise."

It would be helpful if the Committee Report could clarify the terms "or otherwise" in the definition by providing examples.

5. *Contingent sales—Proposed section 453(h)(2).*—Because we realize that some time may elapse between enactment of this bill and the promulgation of regulations dealing with ratable basis recovery, Committee Report examples of its operation would be helpful in the interim.

We urge that the Committee Report make it clear that an income forecast method of basis recovery would be appropriate, for example, for sales of motion pictures and for certain sales of minerals in place.

For bona fide sales where neither the maximum sales price nor the payment period are fixed and the income forecast method cannot appropriately be used to recover basis, we recommend that basis be recovered ratably over a reasonable period of time. However, basis recovery in any year should be limited to payments received in that year. Any basis thus deferred should be added to the remaining unrecovered basis and recovered over the remainder of the recovery period.

Other matters for committee consideration

We also urge that early consideration be given to the Federal Tax Division's recommendation (attached) concerning changes from the accrual to the installment method of reporting sales of property by dealers. We believe this is a noncontroversial related problem area that calls for swift consideration.

Under present law, a dealer in property is subject to the possibility of double taxation for all or a portion of the gross profit on installment payments received during the year of adoption of the installment method (and subsequent years), which are attributable to installment sales arising from pre-adoption years. This can occur by virtue of the provisions of present § 453(c) which are not changed under H.R. 6883. (See proposed Section 453A(b).)

To deal with this problem under present law, knowledgeable taxpayers either (1) "sell" their installment receivables on the last day of the taxable year before the year of adoption of the installment method, or (2) transfer the installment receivables to an affiliate (e.g., a wholly-owned subsidiary). Thus, collections on the receivables are not made by the dealer, in its own right, during any year when it uses the installment method of reporting income from dealer installment

sales. In this connection, it should be noted that the Internal Revenue Service has regularly issued private letter rulings confirming such favorable treatment.

The unadvised taxpayer, however, may suffer the illogical consequences of double taxation for having failed to solve the problem of § 453(c) by such a form-oriented transaction which serves no other business purpose.

The problem under present law can be remedied only by legislative action. We suggest that the cure be a simple provision that collection on pre-adoption year installment obligations of an accrual-basis taxpayer be excluded from the computation of gross income for a dealer in property who adopts the installment method with respect to such sales.

At a time when this committee is considering the simplification and revision of § 453 to eliminate unnecessary complexities and improve the tax logic underlying its provisions, we urge that you address this problem, either in the context of H.R. 6883 or separately, in the manner described above.

SECTION 453—ELIMINATION OF DOUBLE TAXATION UPON CHANGE FROM ACCRUAL TO INSTALLMENT BASIS

Upon a change from the accrual to the installment basis of reporting taxable income from installment sales by dealers in personal property, installment payments actually received during the year on account of sales made in a taxable year before the year of change should be excluded in computing taxable income for such year of change and for subsequent years [section 453(c)].

Under the Internal Revenue Code of 1939 a taxpayer changing from the accrual method to the installment method was not permitted to exclude from gross income for the year of change and subsequent years the gross profit which had been included in income and taxed in an earlier year when the taxpayer was on the accrual basis. The result was that such taxpayer was taxed twice on the same income.

The Committee Reports accompanying the Internal Revenue Act of 1954 state that with the intention of eliminating this double taxation, Congress enacted section 453(c) of the Internal Revenue Code. Unfortunately, that section does not go far enough, for it still requires that the gross profit from installment payments received after the change to the installment method be included in gross income in the year of receipt even though it had previously been taxed under the accrual method.

Actually, section 453(c) does not accomplish its intended purpose. Only limited relief is provided from the double tax penalty. Even if it is assumed that the tax rate and gross income are the same for the earlier year and the year of change, the net income and the final tax in the earlier year would probably have been smaller because the expenses of sale would have been deducted in the earlier year under the accrual method. Thus, the section 453(c) adjustment will not eliminate all the tax in the second year resulting from the inclusion of the gross profit. The double tax of section 453(c), however, can be avoided by selling the receivables prior to the election to report on the installment basis. Although this technique does provide relief from the double tax, it adds to the incongruity of section 453(c).

In order to accomplish equity among taxpayers who change from the accrual to the installment method of accounting for installment sales, taxpayers who adopted the installment method originally, and taxpayers who sell their receivables prior to changing to the installment method, and, in order to follow the expressed intent of the Congress, section 453(c) should be amended to permit a changeover to the installment method without double taxation.

Mr. ROSTENKOWSKI. Thank you.

Welcome to the subcommittee, Mr. Davis. Will you proceed.

STATEMENT OF THOMAS A. DAVIS, COUNSEL, NATIONAL CATTLEMEN'S ASSOCIATION

Mr. DAVIS. Thank you, Mr. Chairman. My name is Thomas A. Davis and I am here today representing the National Cattlemen's Association. My professional address is 499 South Capitol Street, SW., Washington, D.C.

Let me say that in view of the testimony that has preceded me and the gentlemen who have given that testimony, being such prestigious tax experts, I can add little but to join with them in their comments, and I will be brief.

In previous testimony before this subcommittee on H.R. 3899, the National Cattlemen's Association expressed its general support for revision and simplification of the installment sale provision but objected to the provision in the bill denying installment sale treatment to sales between related parties.

Since that time, another bill has been developed which is now pending before the subcommittee which treats installment sales between related parties entirely differently. The new bill provides a rule which triggers recognition of gain only when there is a resale by the initial purchaser. This is generally along the lines which we suggested earlier.

Therefore the National Cattlemen's Association now supports the provision in H.R. 6883 dealing with sales between related parties as well as the bill in general.

I would like to comment on the provision in the bill which prohibits acceleration of recognition of taxable gain to the initial seller in any case where it is established to the satisfaction of the Internal Revenue Service that the resale did not have as one of its principal purposes avoidance of Federal income taxes.

The National Cattlemen's Association would urge that the subcommittee make it clear that such circumstances as bankruptcy or foreclosures, disposition caused by drought and other kinds of forced sales would come within the exception as not being motivated by Federal income tax avoidance purposes.

In addition we urge the subcommittee to make it clear that dispositions of property such as charitable transfers, gifts, and transfers to a controlled corporation or partnership will not accelerate the recognition of the taxable gain of the initial seller. This was suggested in the pamphlet describing H.R. 6883 prepared by the Joint Committee on Taxation.

In brief, we would say just that we hope that the committee makes it clear in the legislative history of the bill that the Internal Revenue Service should broadly interpret the provision which excepts transactions where the principal motivation or purpose is not tax avoidance.

Finally, I would like to make one comment about the structural improvements as contained in the bill pending before you. The pamphlet describing the bill prepared by the Joint Tax Committee states that the gain from the sale of property not required to be inventoried by a farmer under his method of accounting is intended by this bill to be eligible for installment sale reporting. The NCA urges that this statement in the pamphlet be incorporated into the legislative history of the bill and we applaud the effort along these lines because it has been a problem for some farmers.

In closing, let me also add that the National Cattlemen's Association applauds the subcommittee for its efforts toward simplification and revision of the installment sales provision. We realize that it is not a simple task and there is never a perfect answer. We think that the bill now before you is an acceptable compromise and we urge the subcommittee to work toward the enactment of the bill. Thank you.

[Mr. Davis' prepared statement follows:]

STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION

Mr. Chairman, my name is Thomas A. Davis and I am appearing before you today as Washington tax counsel for the National Cattlemen's Association. The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry—including cattle breeders, producers and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 15 affiliated national breed organizations.

In previous testimony before this Subcommittee on July 27, 1979, I expressed the general support of the National Cattlemen's Association for revision and simplification of the installment sale provision as contained in H.R. 3890. However, I expressed opposition, on behalf of NCA, to the provision in H.R. 3899 which denies installment sale treatment with respect to sales between related parties.

The bill now pending before this Subcommittee, H.R. 6883, treats installment sales between related parties entirely differently than does the original bill. H.R. 6883 provides a rule which triggers recognition of gain only when there is a resale by the initial purchaser. This treatment is generally along the lines we suggested in our prior testimony. Therefore, the National Cattlemen's Association now supports the provision in H.R. 6883 dealing with sales between related parties, as well as the bill in general.

While NCA agrees with the treatment of related party sales as contained in H.R. 6883, I would like to make several more specific comments. First, NCA endorses the provision in the bill which provides that an involuntary conversion of property after a related party sale does not accelerate recognition of the installment gain to the initial seller. Also, we endorse the exception with regard to dispositions which occur after the death of the first seller or the death of the person acquiring the property in the first disposition.

NCA also supports the provision in H.R. 6883 which prohibits acceleration of recognition of taxable gain to the initial seller in any case where it is established to the satisfaction of the Internal Revenue Service that neither the initial sale nor the resale had as one of its principal purposes the avoidance of Federal income taxes. However, NCA strongly urges the Subcommittee to make it clear that a disposition which was forced by bankruptcy, such as a foreclosure, or a disposition caused by a drought condition would come within the exception that the disposition did not have Federal income tax avoidance as one of its principal purposes. In addition, we urge the Subcommittee to make it clear that dispositions of property such as charitable transfers, gifts and transfers to a controlled corporation or partnership will not accelerate recognition to the initial seller. This was suggested in the pamphlet describing H.R. 6883 prepared by the Joint Committee on Taxation. Finally, we urge the Subcommittee to make it clear that tax-free exchanges under Section 1031 are not dispositions which trigger recognition to the initial seller.

Before closing, I would like to make one comment about structural improvements to the installment sale provision. The pamphlet describing H.R. 6883, prepared by the Joint Committee on Taxation, states that gain from the sale of property not required to be inventoried by a farmer under his method of accounting is intended by this bill to be eligible for installment method reporting as gain from a casual sale of personal property. NCA urges that this statement in the description pamphlet be incorporated in the legislative history of the bill.

In closing, let me say that NCA applauds the Subcommittee for its efforts toward an acceptable simplification and revision of the installment sale provision. We realize it is not a simple task and there are no perfect solutions. H.R. 6883 is an acceptable compromise and we urge the Subcommittee to move forward toward enactment of the bill.

Thank you for this opportunity to express our views.

Mr. ROSTENKOWSKI. Mr. Murdoch is next.

**STATEMENT OF CONVERSE MURDOCH, PRESIDENT, SMALL
BUSINESS COUNCIL OF AMERICA, INC.**

Mr. MURDOCH. I am appearing as president of the Small Business Council of America. My office address is 300 Delaware Avenue, Wilmington, Del., which is 118 miles south of the faculty lounge at Columbia Law School. Also, I might say that is 180 degrees.

Since I am apparently the only one up here today who does not think this is a perfect bill, it may be that I'll be about as welcome as a bastard at a family reunion in saying some of the things I am going to say.

The Small Business Council does think that this legislation is a great improvement over the originally introduced bills. I would not go so far as Professor Ginsburg and say it is a perfect bill. I would say that in the light of the brain power that went into improving this legislation in the last 6 months, certainly with very little more effort those same people could make it a perfect bill. I think what has happened is a definite move in the right direction, but it does not go quite far enough.

I am convinced that as a regular contributor to the Columbia Law School Alumni Fund, I can prevail upon the school to release Professor Ginsburg so that this can be a perfect bill.

Small business has a particular interest in how installment sales are treated because small businesses are often transferred either to related parties or unrelated parties in installment sale transactions. With prime interest rates at 20 percent or 19 $\frac{7}{8}$ %, or whatever they are today, nobody has any cash in the community that I come from. Certainly, no small businessman attempting to acquire another business has any cash. As a result, now particularly small businesses are not going to be transferred except by debt of the owner or by sales on an installment basis. That is why small business has such an interest in this.

The related party rules are our principal concern, as they were last summer when we talked about the original legislation. I applaud the idea of going to a test based on the resale rather than the flat prohibition against sales between related parties. I think the exceptions that have been worked into this legislation are well intentioned and with some revision could be made perfect.

On the involuntary conversion rules I urge that in the statute—not in the committee report, but in the statute—there be an exception where the second disposition is a result of bankruptcy or a foreclosure-type sale. Such a second sale can be much more devastating to a family group than a condemnation, for example. A condemnation that causes a second sale would automatically free the first transferor of any penalty under the bill. Yet, a condemnation often results in a healthy payment of cash to the second transferor.

However, a foreclosure sale or bankruptcy transaction almost always results in no cash and I consider that a greater hardship situation than a condemnation which would be "home free." I urge the staff in revising the legislation, as I hope they will, to put that in as a statutory exception.

Next on the death of the transfer exception—Professor Ginsburg and his fellow draftsmen are apparently all liberated husbands who are not compelled to own their property jointly with their wives. Most of our clients are not in that position. Most real estate—farms or other types of real estate—throughout the country is held in some sort of joint ownership. Such real estate interests are usually transferred to transferees who will hold it in joint ownership with spouses.

The legislation, as I understand it, says that if a father sells a farm to a son, if the farm was held by the father and the mother as joint owners, and the father dies within the 2 years, that would not qualify for the exception; whereas, if the father owned the farm alone and sold it to the son, and the father died, that would qualify for the exception.

That seems an unfair distinction to me. It can happen on the other end. The father can transfer the farm to a son and daughter-in-law and the son can die within 2 years and yet this would not be covered.

This is the sort of thing that I would urge be covered in the statute. Do not depend upon committee reports for that kind of exception.

On the lack of tax avoidance, I think the exception which has been put in the bill for transactions in which there is no tax avoidance is a good escape provision and I urge it be kept in, but that it be changed. As now written, it says that the lack of tax avoidance has to be demonstrated to the satisfaction of the Internal Revenue Service. I think the subcommittee quite properly assumes when they pass legislation of that kind that they are talking about convincing such persons as Mr. Halperin and Mr. Lubbock, who appear before you regularly and you know are reasonable people who would never take an arbitrary attitude in determining government positions. They are not who we in the provinces deal with on these matters.

We deal with revenue agents who are perfectly nice people, but they are not the people you see appearing here. I urge that you give us a chance in the provinces. If we cannot convince a revenue agent that there is no tax avoidance, at least, give us a chance to convince a judge or jury that there is no tax avoidance.

However, under the rule as it is here stated, even if a judge or jury is convinced that there was no tax avoidance connected with either transaction, the taxpayer would lose unless he could prove that the Internal Revenue Service abused its discretion in not agreeing with that conclusion. Anyone who has tried cases can tell you that that is a nearly impossible burden to carry. There are some cases, once in a while, where it is held that a government official has abused his discretion. Those are the rarities, though. That puts to much of a burden on properly motivated taxpayers.

On the extension of the statute of limitations, that is a particularly unfair provision because it says that the statute of limitations will never run on deficiencies against the first transferer unless the second transferer gives notice to the Treasury Department of the second disposition.

That assumes that the second transferer in related parties sales is always going to be related to and under the control of the first transferer. This is not the way it is in many situations.

On the effective dates, I would urge at least one change. In my statement I have suggested several. In a situation where you are writing a blank check to the Treasury Department to write regulations on things as important as this, the effective date should not precede the date on which the Treasury regulations become final.

Mr. Chairman, I appreciate the opportunity to be here and I ask that my written statement be included in the record.

Mr. ROSTENKOWSKI. Without objection, your entire statement will be included in the record.

[The prepared statement follows:]

STATEMENT OF CONVERSE MURDOCK, PRESIDENT, SMALL BUSINESS COUNCIL OF AMERICA, INC.

SUMMARY OF STATEMENT

The Small Business Council of America, Inc. (SBCA) believes that the now proposed legislation is a substantial improvement over the legislation considered by the subcommittee at hearing during the summer of 1979.

However, SBCA urges:

1. The rules regarding resales by related parties be improved by better stating the exceptions and by adding other needed exceptions.
2. Demonstration of lack of tax avoidance not require the concurrence of the Internal Revenue Service.
3. An extension of the statute of limitations on tax deficiencies not depend on actions of related, but uncontrolled, parties.
4. The legislation not give the Treasury such broad rule making authority.
5. The effective dates be revised in the interests of fairness to the many taxpayers who are uninformed about the legislation.

GENERAL STATEMENT

The Small Business Council of America, Inc. (SBCA) is a nationwide organization of small business people which monitors and comments on legislation and regulations impacting small businesses—particularly in the tax area. This statement is submitted on behalf of SBCA by me as the President of the organization.

Interests in small businesses (including farms and ranches) have customarily been transferred in transactions involving the purchaser's payment of the consideration over an extended period of time. In some cases, such transactions, involve sales of businesses between related parties. For example, it's not unusual for a parent who has owned and operated a small business to sell the business to one or more of his children on an installment basis. In other situations, such sales are made to unrelated parties. In either event, it's common for the purchase price to be payable over an extended period.

In today's climate of 20 percent prime interest rates a sale of a small business on anything other than an extended payment basis is a rarity. Except for large publicly-held organizations interested in passive investments in small businesses (coupled with a hoped for sale in a short time at capital gains rates), it's almost unheard of for the purchaser of an interest in a small business to have enough capital to pay a substantial part of the purchase price in cash.

It's for the foregoing reasons that small businesses have a particular interest in income taxation of gains from sales on an installment basis.

Complexities which interfere with the ability to consummate installment sales have a substantial negative impact on small businesses.

This is not to say that only small businesses have an interest in matters of this kind. However, small businesses have a particular concern in this area.

If transfers of small businesses to related or unrelated parties cannot be accomplished with understandable, simple and workable installment sales rules—more and more small businesses will be transferred to large corporations with publicly traded stock in tax-free "stock for stock" or "stock for assets" transactions. Accordingly, anything which inhibits installment sales of interests in small businesses to other small business people (whether related or unrelated) is bound

to accelerate the trend towards concentrations of economic power in the hands of large corporations with publicly traded stock available for use in acquisition of smaller businesses.

THE BACKGROUND OF THIS LEGISLATION

In the summer of 1979 this Subcommittee and the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee held hearings on H.R. 3899 and S. 1063. SBCA and other organizations appeared at those hearings and voiced strenuous objections to various parts of those bills. The cited bills would have made substantial changes in the tax rules regarding installment sales. Comments as to the earlier bills centered on the provisions which would have, in effect, forbidden installment sales reporting of gains from sales between related parties.

Presumably as a result of opposition expressed at those hearings and elsewhere, H.R. 3899 and S. 1063 were substantially revised and reintroduced as H.R. 6883 and S. 2451.

SBCA is of the opinion that the new bills are a considerable improvement over those originally introduced. For that improvement, we are grateful.

However, SBCA believes that H.R. 6883 (and its companion S. 2451) are in need of substantial revision. In the balance of this statement references to "Prop. Sec." will be deemed a reference to Proposed Sections of the Internal Revenue Code, as per the amendments made by H.R. 6883.

RELATED PARTIES SALE RULES

Because so many interests in small businesses (including farms and ranches) are sold on an installment basis to related parties who are members of the younger generation in the family, the rules with respect to sales to related parties are a matter of particular concern to small business people. They will obviously be gratified to note that the flat prohibition against installment sales between related parties have been dropped from the legislation. Instead, the new bills provide a general rule that if an installment sale between related parties is followed by a resale within two years, the first seller must immediately report gain with respect to any amounts received by the second seller. That will follow whether or not the first seller receives additional cash and regardless of whether he has the right to ask for such added cash. While that is an obvious improvement over a rule which flat prohibits installment sales between related parties—it still will result in many perfectly bona fide transactions either being subjected to the penalty provisions of the proposed legislation or subjecting the parties involved to uncertainties as to whether the penalty provisions will apply.

THE EXCEPTIONS TO THE 2-YEAR RESALE PROVISION

Involuntary conversions

One of the exceptions to the two-year retransfer rule is found in Prop. 453(e) (6) (B). That exception is with respect to a second disposition which is part of a compulsory or involuntary conversion within the meaning of Code Section 1033. However, there is an exception to an exception to the effect that the penalty provision will apply unless "the first disposition occurred before the threat or imminence of the conversion." This assumes that there is a precise and easily identifiable point in time when there is first a threat of involuntary conversion, such as a threat of condemnation. That simply isn't the way it is in the real world. Anyone who has had experience with condemnations knows that it is impossible to point to a particular day and say positively that that is the day when there was a threat or imminence of condemnation. This exception to the exception is simply not workable.

If it is felt that there must be this exception to the exception—it should be gauged by an easily identifiable event, such as the filing of a court proceeding for condemnation.

Death of transferor or transferee

Another exception to the two-year resale rule has to do with a second transfer following the death of the person making the first disposition or the death of the person acquiring the property in the first disposition. See Prop. Sec. 453(e) (6) (C).

This is a good provision but it does not go nearly far enough. The provision as drafted would cover only a simple situation such as one in which a father transfers a farm to a son in an installment transaction and then either the son or the father dies before the son has made a further disposition. However, there will be many situations which do not fall into that particular mold. For example, the father may enter into an installment sale of property to a corporation controlled by the son or to a partnership of which the son is a substantial participant. Assume in such a case the son died within two years. Assume that for the same reasons which would have impelled a resale had the deceased son held the property directly—the acquiring entity resells. That transaction would presumably not be exempt under the cited part of the proposed new law.

Real estate (including farms) is often held by a father and mother as joint owners. The exception would apparently not apply if the parents sold property to a child and within two years the father (but not the mother) died.

Another very common form of transaction not covered by this exception is the one in which a father transfers property to a son and daughter-in-law as tenants by the entireties. Within two years of the father's sale on the installment basis to the son and daughter-in-law, the son dies. Apparently, this transaction would also not qualify for relief. It should.

This exception should be considerably broadened to include situations such as those just posed.

LACK OF TAX AVOIDANCE

Prop. Sec. 453(e)(7) is meant to be a general relief provision for situations in which it can be demonstrated that there was no tax avoidance associated with either the first disposition (i.e., the original installment sale transaction between related parties) or with respect to the second disposition (i.e., the one occurring within two years of the first disposition).

Subject to some revisions to be suggested in a minute—this is a good and needed type of general relief provision.

The provision should be revised to eliminate the requirement that the lack of tax avoidance must be "established to the satisfaction of the [Internal Revenue Service]". Stating the exception in its now proposed form will put an intolerable burden on many properly motivated taxpayers.

The requirement that lack of tax avoidance be demonstrated to the satisfaction of the Internal Revenue Service will impel well advised and sophisticated taxpayers to undergo the expense and delays associated with trying to get advance rulings from the Internal Revenue Service. Often the delays associated with getting a ruling are so long that the proposed transaction aborts.

In addition, giving that sort of power to the Internal Revenue Service inevitably leads to situations in which the Internal Revenue Service imposes extralegal demands for concessions by the applicant for the ruling as a condition to getting a favorable ruling. This is "government by bluff" at its worst.

In the event of litigation regarding the availability of this exception in its present form, the taxpayers will be subjected to a well nigh impossible task of proving not only that there were no tax avoidance motives associated with either transaction, but in addition, that the Internal Revenue Service abused its discretion in refusing to so find.

This exception should be changed to merely a simple proposition that the two-year resale rule does not apply if lack of tax avoidance can be demonstrated. That would mean that in litigation, if a judge or jury became convinced of the lack of tax avoidance, the taxpayer would win whether or not the Internal Revenue Service acquiesced in such a finding. Such a rule would conform with the provisions of Code Section 302(c)(2) having to do with waiver of the family attribution rules in stock redemption situations where tax avoidance was not one of the principal purposes of a transaction.

Another flaw in this general escape provision is that it requires that there be a demonstration that neither the first nor the second disposition had tax avoidance as one of its principal purposes. Assume the situation in which an individual sells property on an installment basis to a corporation controlled by him at the time of the transfer. Assume that thereafter the first transferor lost control of the transferee—corporation and the corporation thereafter sold the property in a transaction which IRS thought had a tax avoidance motive. The result would be that the first transferor would be subject to the penalties of

the statute. This is particularly unfair in the situation where the first transferor has no control over either the event of resale or the motives of the second transferor. This is an example of "beating the wrong dog."

It should be sufficient to show that there was no tax avoidance motive on the part of the first transferor in connection with the first disposition.

FORECLOSURE TYPE RESALE

There is a need for an exception to the two-year resale rule where the second disposition is in connection with a foreclosure of a lien on the transferred property. Such a foreclosure sale can be just as involuntary for this purpose as one falling under Code Section 1033. In fact, the penalty aspects of this can be even more harsh in the case of a disposition in the form of a foreclosure sale. If the second disposition is a lien foreclosure sale, it will almost always mean that the second transferor has absolutely no cash as a result of the so called "sale". Thus, even if the second transferor is inclined to help the first transferor out of his cash difficulties, he couldn't do so.

THE INVOLUNTARY EXTENSION OF THE STATUTE OF LIMITATIONS

Prop. Sec. 453(e)(8) provides that the statute of limitations on assessments of deficiencies against the first transferor does not expire until two years after the date on which the second transferor notifies the Internal Revenue Service about the second disposition. This is a particularly unfair provision. It assumes that in all cases of related party sales there is a complete identity of interest and unlimited communication between the related parties. That simply isn't the fact. As a result, the first transferor may find that many years after the first disposition he can be hit with a tax deficiency because of a transaction over which he had absolutely no control and of which he had no knowledge. This provision should either be eliminated or drastically changed to eliminate such an unfair result.

SPECIAL RULES ON "MARKETABLE" SECURITIES

In the case of marketable securities, the proposed legislation would cause acceleration of realization of gain by the first transferor even where the resale occurs more than two years after the first disposition. Prop. Sec. 453(e)(2)(A). Prop. Sec. 453(f)(2) defines marketable securities as securities "for which, as of the date of the disposition, there was a market on an established securities market, or otherwise." That is a very plastic definition and one which goes well beyond what most people would assume was meant by a marketable security. Presumably under that definition, every security is marketable since it could be sold somewhere on some terms. The definition is also unclear with respect to the situation in which a security is marketable at the time of the first disposition but not at the time of the second disposition or vice-versa. There are many situations in which a security can be non-marketable on one day and within two years become marketable, e.g. by listing on an established securities market. By the same token, a security can be listed on an established securities market one day and later be de-listed.

This definition needs to be considerably tightened.

SPECIAL RULE FOR "READILY TRADABLE" INSTALLMENT OBLIGATIONS

Prop. Secs. 453(f)(4) and (5) in effect treat readily tradable obligations issued by a corporation or a government (or political subdivision thereof) as the equivalent of cash. That rule is bound to lead to hardship situations and unfair results. This provision also raises a technical question whether it overrides the provisions of Code Sec. 354(a) in a reorganization in which securities are exchanged for securities.

THE DELEGATION OF RULE-MAKING AUTHORITY FOR SALES WITH INDEFINITE GROSS PROFIT OR TOTAL CONTRACT PRICE

Prop. Sec. 453(h)(2) turns over to the Treasury Department the job of writing rules to cover cases in which the amount of the gross profit or the total contract price cannot be easily ascertained.

Presumably this provision is meant to change long-standing law to the effect that where the sales price is indefinite and the buyer's obligation has no deter-

minable value, the taxpayer is entitled to recover basis before reporting gain. While existing law may strike some tax technicians and academicians as creating a loophole—it is submitted that in the whole scheme of things this is a very tiny problem. Yet, the solution of ratable basis recovery is apparently so difficult to articulate that the whole matter is turned over to the Treasury for issuance of regulations.

To those taxpayers adversely effected by a change in the rule, ratable basis recovery can have devastating effects. However, for the government, any theoretical short term loss of revenue by continuing to apply the old law is of minor consequence.

It's not unusual for certain types of property to be sold on the basis of a total purchase price determined by events occurring after the sale. For example, a patent may be sold in exchange for royalties of a percentage of proceeds from sales of the patented item. At the time of the sale, no one knows whether the patent will remain valid, how successful the exploitation of it will be, the level of sales, the timing of the sales and similar factors which effect the payments to the seller of the patent. Similar type sales occur in connection with transactions involving natural resources. Many going businesses are sold for a price to be determined on the basis of later events. For example, the sale price of a business may be measured by the sales or profits of the purchased entity after the sale is consummated. Such arrangements are not entered into for tax avoidance motives—they are done because they make good business sense. There is no need for revenue which can possibly justify adding tax complexities with respect to such sales.

If there is a need for precision and new law in this area, it should be undertaken through statutes written by Congress and thus available for review by the public and Congress before enactment rather than through issuance of a blank check to the Treasury to cover the matter in regulations.

EFFECTIVE DATES

The bill provides that the legislation will in general be effective with respect to dispositions made after the date of enactment of the bill in taxable years ending after such date of enactment. That seems fair.

However, if the blank check to the Treasury to write regulations with respect to indefinite transactions remains in the bill, it would seem only right that the effective date for transactions covered by such regulations should not be earlier than the date such regulations become final. This is particularly so when the legislation puts taxpayers to an irrevocable election regarding coverage. As a minimum, the election should remain revocable until some decent interval after the regulations become final.

In the case of installment sales to related parties, the bill provides that it will become effective for dispositions made after March 31, 1980. Many persons were not aware of this legislation until well after March 31, 1980. In fact, there are probably many persons who are still not aware of this legislation and will not become aware of it until much later.

The draftsmen are to be commended for at least giving some delay between announcement of the bill and its effective date.

As presently drafted, the effective date provisions are unclear with respect to a situation in which the first disposition is to a related party and occurs after March 31, 1980 and the second disposition occurs before the enactment of this legislation.

This special early effective date gives an entirely unwarranted advantage to those practitioners who in one way or another were aware of the imminence of this legislation. Such a short lead time effective date provision puts practitioners who were not privy to that information at a serious disadvantage.

SBCA recommends that all effective dates under the new law be stated in terms of transactions occurring after the enactment of the statute except those in which regulations are to fix the law. In case of the latter, the effective date should be with respect to transactions occurring after the proposed regulations become final.

CONCLUSION

SBCA believes that the now-proposed legislation is a substantial improvement over the earlier legislation about the same subjects. However, SBCA believes that the legislation requires considerable reworking. Officers of SBCA stand ready to assist the Subcommittee and its staff in working on the numerous technical problems facing the draftsmen of this complex legislation.

Mr. ROSTENKOWSKI. Mr. Layman.

**STATEMENT OF MICHAEL L. LAYMAN, ATTORNEY/CPA, ON BEHALF
OF HOUFF DAIRY FARMS, INC., HARRISONBURG, VA.**

Mr. LAYMAN. I am honored to be here among what I consider to be tax giants. My office address is 92 North Liberty Street, Harrisonburg, Va.

I am an attorney. Harrisonburg is the hometown of 7-foot 4-inch Ralph Sampson, another giant that many of you may be familiar with.

I am here to basically support H.R. 6883. I am glad to see it. However, there is another area not previously addressed that I think needs improvement. My suggestion deals with subchapter S corporations which have their taxable income taxed at the shareholder level and how H.R. 6883 relates with installment sales made by those corporations.

If H.R. 6883 is not changed slightly, I think we will continue to see some harsh and unexpected consequences to many small taxpayers who are suddenly forced to pay taxes on gain when they will not receive the cash on that gain for many years to come. Without the change, we will continue to have unnecessary complexities in the subchapter S area.

Let me share with you a fact situation that has occurred already close to my community. A small farmer who owns and operates a subchapter S corporation is going out of business and sells assets as compared to selling his stock. He receives an installment note payable over a long term at what then was a fairly reasonable interest rate, 7 to 8 percent. We did not have H.R. 6883 in effect then, and the attorney then involved could not wisely use a section 337 liquidation when the corporation received the installment note. However, even if H.R. 6883 had been in the law, the problem still could have happened. What happens is that where the provisions of 337 are not satisfied, this installment note, when distributed, is going to be taxed immediately on its full value to the shareholder as compared to being subject to tax as and when paid.

Since subchapter S corporations are to be taxed at the shareholder level, why do we not continue to allow that particular shareholder to be taxed as the cash is received? This particular taxpayer is in a no-win position. If the corporation does not distribute the note and it has no other active trade on business, it suddenly becomes a personal holding company. Any income not distributed is taxed at 70 percent in addition to the regular corporate tax rate. This problem can be easily remedied by slightly amending the statute to allow subchapter S corporations to distribute their installment notes without immediate tax consequences, when such notes arise from the sale of property whether or not the sale resulted from a 337-type liquidation or not.

A second fact emphasizes that this problem can also occur where even the best tax advice has been available. Again, we take the farmer or any small businessman who has several tracts of land or pieces of real estate and runs into financial problems due to high interest, crop failures, and is forced to sell one tract of land. Again, he operates as a subchapter S corporation, and he probably sells in today's market on an installment basis, maybe to his neighboring farmer. He intends

at that point to continue farming and, therefore, believes that he will be taxed at the shareholder level, as the note is paid. But he has more problems. A year passes and then in the second year he is forced to sell the rest of his farm assets on an installment sale basis.

Again, let us say for some reason he sells assets and he is unable to sell stock. What are the tax consequences? Under H.R. 6883, it will now for the first time protect the second note to allow income tax on the gain to be paid on an ability-to-pay basis. But what about the first note? Again, this note cannot be distributed without immediate tax consequences to the shareholder, and the shareholder has no cash with which to pay that tax. I feel the solution I recommend is a simple one. It does not give an opportunity for tax avoidance. Subchapter S corporations are limited to corporate taxpayers of 15 or less shareholders and, again, if we are here to tie legislation to simplification and the ability-to-pay concepts, I cannot see where there would be any objections to my proposal.

I request that my written testimony be entered in the record and I appreciate the opportunity to be here, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF MICHAEL L. LAYMAN, ATTORNEY/CPA, APPEARING ON BEHALF OF
HOUFF DAIRY FARM, INC.

The legislative amendment to H.R. 6883 that I propose promotes further simplification as well as a taxing concept based on the ability to pay, and the following fact situation illustrates this: A subchapter S corporation which operates a dairy farm decides to sell all of its assets due to the health and age of its four shareholders. The shareholders seek the advice of their attorney and realtor, and shortly thereafter, the sub S corporation sells its land, equipment and dairy herd for an installment note in the amount of three hundred thousand dollars (\$300,000) payable over fourteen (14) years with interest at seven percent (7%). The gain on the sale is two hundred thousand dollars (\$200,000), representing many years of hard work and the effects of inflation on land values.

The shareholders, as subchapter S shareholders, have reported all corporate income at the shareholder level and they assume that the gain from the installment note payable to their corporation when distributed to them in liquidation of the corporation will also be taxed to them individually under the subchapter S rules and the installment sales rules as an installment sale over the fourteen year period.

After the real estate closing, the shareholders are advised by another attorney that the installment note for three hundred thousand dollars (\$300,000), payable to their corporation, cannot be distributed to them individually in liquidation of the business as they had expected without disastrous tax consequences. They learn that if the corporation distributes the note to them as shareholders, they will recognize the entire two hundred thousand (\$200,000) gain for income tax purposes under section 453 in the year the note is distributed even though the note is to be paid over a fourteen-year period.

They also learn that their corporation will soon not qualify as a "subchapter S corporation" if it does not distribute the note since it will not be operating an active trade or business, i.e. more than twenty percent (20) of its gross receipts are from interest, which is prohibited by the subchapter S statutes. They are told that if they are not a subchapter S corporation, they will be a regular (or subchapter C) corporation and all of the income (both capital gain and interest) will be taxed at the corporate level.

Any money distributed to the individual shareholders will be treated as dividends and, therefore, the income will be taxed twice, once at the corporate level (since the corporation gets no tax deduction for dividends paid) and again at the shareholder level. The shareholders need this money to live on, but still they ask if they can leave the money in the corporation to avoid this double taxation. They learn that this would be even worse because their corpora-

tion is now a personal holding company since sixty percent (60) or more of its "adjusted ordinary gross income" is from interest, and if the interest received by their corporation is not distributed, the interest income will be hit with a seventy percent (70) personal holding company tax under Section 541 in addition to the regular corporate income tax.

Our taxpayers are in a no win position. They could have liquidated their corporation under Section 333 of the Internal Revenue Code and then individually sold the farm assets, but their attorney did not realize that the entire two hundred thousand dollar (\$200,000) gain on the installment note would be recognized on its transfer to the shareholders. Why didn't the attorney consider this alternative? The answer is directly related to the complexity and traps within the tax law, but as later illustrated, even the best tax advice can lead to this no win position.

My proposed solution would be a simple one and a help for the many taxpayers who are caught in this trap. My proposal would allow a subchapter S corporation which is in the process of liquidation to distribute installment sale notes to its shareholders and have the notes taxes as paid instead of when distributed.

Subsection (g) of HR 6883 takes one step toward my proposal. HR 6883 as proposed for the first time allows a corporation in a section 337 liquidation to distribute to its shareholders an installment sale not payable to it without requiring gain to be recognized by the shareholders until the note is actually paid. The basic tax consequences of a section 337 liquidation election is, therefore, to produce a tax at the shareholder level on an ability to pay basis and not at the corporate level when the note is distributed.

Existing law does not allow any corporation (regular or sub S) to distribute an installment note without immediate tax recognition. HR 6883 would make it much easier for businesses to negotiate the sale of their assets in complete liquidation at the corporate level because a corporation liquidating under 337 would avoid immediate taxation on installment notes distributed.

My proposal would extend this right to subchapter S corporations with respect to all installment sale obligations. Subchapter S corporation tax law is intended to create tax consequences at the shareholder level and I believe the regulations to Section 453 requiring a sub S corporation to recognize this gain immediately have created all along an unintended result.

Should not a sub S corporation which liquidates farm A on an installment sale basis in year 1, and farm B on an installment sale basis in year 2, be allowed to distribute both installment notes to its shareholders without immediate taxable consequences? H.R. 6883 would only allow the installment sale of year 2 to qualify for tax consequences tied to the actual receipt of funds. Why continue a concept that violates this fundamental principle of taxation?

Those proposing H.R. 6883 to date have overlooked its specific application to subchapter S corporations but instead have written with only regular corporations in mind. In speaking with various representatives of the AICPA and the ABA, they have admitted such.

I support H.R. 6883 but let's take a few more minutes to perfect it. I'm from the Shenandoah Valley where we have hundreds of small farmers. There are many farmers who are operating as sub S corporations who may be forced to liquidate one of several farms with the hard times facing them today. They will probably sell on an installment sale basis. If they are then forced by high interest rates, crop failures, etc. to sell their remaining acreage more than 12 months later, they will be in the same disastrous consequences that my first example illustrates with no way out.

My proposal does not open the door to tax abuse. Subchapter S corporations are limited to corporations with 15 or fewer shareholders. Subchapter S tax laws are in existence to cause taxation at the shareholder level. The installment sales rules should not change this result but should promote it. The installment sale note distributed from subchapter S corporation should be taxed as paid at the shareholder level for four basic reasons:

- (1) Taxing concepts should be tied to the ability to pay;
- (2) Taxing concepts should promote consistency within the subchapter S rules, i.e. no surprises and especially no harsh surprises;
- (3) Taxing concepts should promote tax simplification; and
- (4) Taxing concepts should not create an opportunity for tax avoidance.

My proposal is consistent with all of the above.

The specific statutory construction I propose would read as follows:

"(h) USE OF INSTALLMENT METHOD BY SHAREHOLDERS OF ELECTING SMALL BUSINESS CORPORATION IN SECTION 337 LIQUIDATIONS.—

(1) RECEIPT OF OBLIGATIONS NOT TREATED AS RECEIPT OF PAYMENT.—

(A) IN GENERAL.—If, in connection with the complete liquidation of an electing small business corporation to which section 337 applies, in a transaction to which section 331 applies the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation which would be taxed at the shareholder level if electing small business corporation status had been maintained, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

(B) OBLIGATIONS ATTRIBUTABLE TO SALE OF INVENTORY MUST RESULT FROM BULK SALE.—Subparagraph (A) shall not apply to an installment obligation described in section 337(b)(1)(B) unless such obligation is also described in section 337(B)(2)(B)."

Thank you for the opportunity to appear today before you, and I welcome the opportunity to answer any questions you might have.

Mr. ROSTENKOWSKI. Thank you, Mr. Layman.

Is there is any other comment that any member of the panel would like to make, or any discussion that you would like to briefly engage in?

Mr. GINSBURG. Mr. Chairman, I just wanted to make a comment or two on Mr. Murdoch's remarks commencing with the one in which—

Mr. ROSTENKOWSKI. That is the 180 degrees?

Mr. GINSBURG. I think Columbia Law School would be delighted to go along with his proposal and release me, but I do not know that it would do much good.

Mr. Murdoch suggests that I had something to do with the drafting of his bill. I would have been honored had that been so. It really is not so. I was involved with others in the process, however.

My comments basically are few. On the involuntary conversion point, the reason I think that the bill incorporates a specific reference to the kind of involuntary conversion Mr. Murdoch mentioned, the one in which a lot of cash comes in, is simply because a lot of cash comes in. It is thus the focus of at least an argument about tax avoidance purpose.

I think it is clear that if father sold to his son and discovers the following year that son has become bankrupt or has suffered some giant form of foreclosure from a third party, there isn't any income tax avoidance. Indeed, father may end up paying more income tax than he should have paid over the long pull. I think the staff pamphlet in its approach is quite clear on this. The suggestion that perhaps it might be reflected in the committee report is not an unreasonable one. But, I do not really think it necessary to amend the statute to deal with this sort of problem. There are so many variations of possible cases in which there is no tax avoidance that to commence a laundry list will end up with the longest simplification bill in history.

I think Mr. Murdoch's point about the coowner problem is quite a good one and perhaps that does deserve some additional focus. On satisfaction of the Internal Revenue Service, the problem of the remarkable hostile revenue agent, in well over 20 years of practice it seems to me I saw some remarkable hostile revenue agents, and so I am sympathetic to the point. But I think that, realistically, it is not the revenue agent that exercises the statutory function of making the

determination that the Secretary or Commissioner is supposed to make.

I think in practice we are aware that in cases of this kind we would look to a determination of higher authority, quite possibly the national office, through a technical advice procedure. So, I think in fairness the provision will work in a quite different way than that suggested by Mr. Murdoch.

Finally, the question of extension of the statute of limitations and the problem of the second transfer, or the son giving the notice, I now realize that Herb Lerner was quite right when he said we had better have a slight clarification in the committee report. I think a closer reading confirms it is intended to be father and not son who gives the notice. It is father's tax return. I think the problem Mr. Murdoch mention, which certainly would exist if it were son, who must notify, does not in fact exist, but a clarification as Mr. Lerner suggested would be in order. Thank you.

Mr. MURDOCH. May I respond? I do not think that a Marty and Con show will ever reach the level of the Ev and Jerry show. However, I would like to respond. On the idea of putting things in committee report—this is a generalization, but this episode points up why we should put things in the statute, and not depend on the committee report.

It has been my observation over a long period of years that committee reports were thought of as deals and if something went in the committee report, then that represents an understanding with the Treasury that the regulations and rulings would be consistent with what was in the committee reports. If that was ever the law or the practice, it seems to have disappeared recently. I am not willing any longer to rely on statements in committee reports as to what the Treasury will do.

So, I urge that things like this be taken care of in the statute. Either that, or the statute should say that everything that is said in the committee report shall have the same force and effect as if it had been a part of the statute.

Next on the idea of getting a ruling or technical advice so that you are not dealing with the capricious agent—that points up why I do not like a rule which says that you must convince the Internal Revenue Service of something. Any time you have to go to the national office of the Internal Revenue Service to get a ruling, you are faced with a real prospect that they will say: "Mr. Murdoch, if your client wants a ruling on this, you will tell your client he must agree to do the following * * *", the client's representative say: "That is not in the law and you cannot make me agree to that." IRS then says: "Your client wants the ruling and you are going to agree to it or we are not going to give you a ruling."

This is government by bluff and I do not think that that is correct. I believe that these rules should be left up to judges and juries, and not the Internal Revenue Service.

Mr. ROSTENKOWSKI. Thank you, Mr. Murdoch.

Mr. Vander Jagt has a question.

Mr. VANDER JAGT. It is not necessary for me to ask any questions. During my absence, what I was going to ask was covered and that

was for the members of the panel to respond to some of the suggestions made by the self-described bastard at the family picnic. So, although I do not have any questions, I want to thank each member of this panel of what has been called tax legal giants for your very fine testimony which is very helpful and thank you also for making it very understandable and pleasant.

Thank you very much.

Mr. ROSTENKOWSKI. I would like to join my colleague in expressing my gratitude for the amount of time and effort that you gentlemen have cooperatively rendered in behalf of what I think is good legislation—legislation that can possibly even be improved, Mr. Murdoch.

Thank you very much. That will conclude this panel.

Will Mr. Silverman, Dr. Stefan, Mr. Sagle, and Mr. Thompson come forward.

Now that I have you firmly in place, I am going to recess this hearing until we have gone over to vote. The subcommittee will stand in recess for 5 minutes.

[Short recess.]

Mr. ROSTENKOWSKI. Welcome to the subcommittee. We appreciate the time that you have taken out of your busy schedules to join us and help us with this legislation.

If you will identify yourselves, you may proceed and we will accept your testimony in the order in which you were called.

STATEMENT OF ARTHUR H. SILVERMAN, WASHINGTON COUNSEL, WINE INSTITUTE

Mr. SILVERMAN. My name is Arthur H. Silverman and I am Washington counsel for Wine Institute, the trade association which represents 342 winery members and thousands of growers in California. California produces almost 90 percent of the wine produced in the United States, and about 70 percent of the wine consumed in this country. I am also speaking today on behalf of the Georgia wine industry and its growers.

The sole purpose of H.R. 5616 is to preserve the historical tax status of wine used in the production of distilled spirits. The wine industry has traditionally sold substantial quantities of wine to distillers and rectifiers who blend the wine with distilled spirits to produce cordials, liqueurs, whiskies, and brandies. The rectifier or distiller—and this is the crux of the situation—is then taxed on the individual component parts of the product rather than on the finished product itself. He pays a considerably lower tax on the wine component than on the distilled spirits portion because of the lower alcoholic content of the wine. Depending on its alcoholic content, the wine that is used is subject to a tax of either 17 cents per gallon or 67 cents per gallon. This contrasts sharply with the tax on distilled spirits of \$10.50 per proof gallon.

In view of the administration's repeated assurances—and I will speak to that later—that the entire wine gallon/proof gallon part of the trade bill in no way adversely affected the wine industry, we were shocked to discover that a highly technical and complex section of the trade bill, section 805, inadvertently leads to the elimination of wine

in distilled spirits products. As of last month, section 805 requires a tax based solely on the proof of the finished product after bottling; namely, the distilled spirits tax of \$10.50 per proof gallon.

If this section is not corrected promptly by H.R. 5616, the wine industry will lose a very important and growing market. Rectifiers and distillers unanimously claim that within a relatively short period of time wine will no longer be used in the formulation of distilled spirits. The reason is purely an economic one. Inasmuch as the cost, exclusive of tax, of a unit of alcohol derived from grapes or wine is much more expensive than alcohol derived from grain spirits, wine would assuredly be displaced by distilled spirits. In turn, the substantially higher, full \$10.50 per proof gallon distilled spirits tax would be passed along to consumers with all of its inflationary aspects. The sole inducement to rectifiers or distillers of using wine in distilled spirits products is the tax advantage which wine has traditionally enjoyed.

It must be pointed out that the U.S. wine industry is already burdened with a tremendous imbalance in international wine trade. In 1978 wine represented a \$568 million trade deficit, 2 percent of the total U.S. trade deficit. The industry justifiably had hoped for some meaningful concessions from the multilateral trade negotiations. None were forthcoming. Now we discover that instead of the trade bill expanding our markets abroad, this provision, if it is not promptly corrected, would severely hurt us here at home.

This harmful provision in the trade bill was not uncovered until July 9, 1979, when the trade bill was already on the House floor. The industry and its growers were faced with an accomplished fact since the trade bill could not be amended.

On July 10, Chairman Vanik, the floor manager of the bill in the House, conceded that the result was "never anticipated" by his committee, and that "we have just become aware of this unintended impact on the wine industry." He stated that he would like the problem corrected in subsequent legislation. I have made his entire statement part of my testimony for the record.

Furthermore, Alan W. Wolff, Chief Deputy to Special Trade Representative Robert Strauss, during the trade bill negotiations, recently wrote that he would "deeply regret any part of the MTN implementing legislation having an adverse effect on the California wine industry." He would assume that "there was no intent on the part of any agency of the Government to revise our taxation of alcoholic beverages in a way that would cause other substances to be substituted for wine in the blending of cordials * * *" and I have made that statement a part of the record also.

It is imperative that this problem be immediately corrected by legislation. The language of H.R. 5616 has been drafted with extreme care. It restores the tax status and, therefore, the market to wine as an ingredient in distilled spirits products by allowing a credit against the distilled spirits tax for the amount of alcohol in the product supplied by wine.

We respectfully urge this subcommittee to immediately report favorably H.R. 5616.

[Attachments to the prepared statement follow:]

ATTACHMENT A

Mr. COELHO. Mr. Chairman, I thank the gentleman for his response.

Mr. Chairman, at this time would the gentleman please clarify for the House the intent of a highly technical section of the trade bill relating to the tax treatment of distilled spirits.

I am referring to title VIII, subtitle A, section 805 (all-in-bond method of determining excise tax on distilled spirits).

Unless it is clarified, the language of section 805 could unwittingly and unintentionally cause severe economic loss to our domestic wine industry.

Mr. Chairman, the wine industry has traditionally sold large quantities of wine to rectifiers who blend the wine with other alcoholic beverages to create "rectified" products such as cordials, liquors, and flavored brandies. The rectifier is then taxed on the individual component parts of the product rather than on the finished product itself. He pays a considerably lower tax on wine than on distilled spirits because of the lower alcoholic content of wine.

However, section 805 would also eliminate an eager market for domestic wine by requiring a tax based solely on the proof of the finished product after bottling, namely, the distilled spirits tax of \$10.50 per proof gallon.

Was it the intent of this section of the trade bill, Mr. Chairman, to undermine the wine industry by drying up a traditional market for its bulk goods which many wineries have come to depend upon?

Mr. VANIK. My answer to that is, no, the result was never anticipated by our committee. We have just become aware of this unintended impact on the wine industry. And, in light of this factor, I would like for our committee to study the matter with a goal toward finding some way to provide a means for addressing ourselves to the problem in subsequent legislation.

I am very happy the gentleman called the attention of the committee to this very, very important point.

ATTACHMENT B

VERNER, LIPPERT, BERNHARD AND MCPHERSON,
Washington, D.C., December 14, 1979.

Re a tax on wine in cordials.

Mr. WILLIAM B. KELLY, Jr.,
Office of the Special Representative for Trade Negotiations,
Washington, D.C.

DEAR BILL: John DeLuca of the Wine Institute called me today to inquire as to what our intention to the course of drafting the Trade Agreements Act of 1979 was with respect to the change in the method of taxation of wine for use in cordials.

As you know the general wine-gallon issue was addressed primarily by Al McDonald during the hearings. His testimony was, however, largely directed towards the effects of repeal of wine-gallon/proof-gallon, rather than the technical aspects of changes in other provisions affecting taxation of alcoholic beverages. In this regard, we deferred to the Department of Treasury.

I understand, however, that an unintended adverse impact on the California wine industry will result from adoption of the proof-gallon method of taxation on the alcoholic content of cordials. Currently, the wine content is taxed on the basis of total volume.

I would like to make it clear that I do not have a client interest in this subject. I am writing to you because I would deeply regret any part of the MTN implementing legislation having an adverse effect on the California wine industry, after the great pains we went through on behalf of that industry in the negotiations.

John DeLuca informs me that the Senate Finance Committee will be considering remedial legislation next Wednesday. I would assume that there was no intent on the part of any agency of the Government to revise our taxation of alcoholic beverages in a way that would cause other substances to be substituted for wine in the blending of cordials, and that a solution could be worked out to the satisfaction of interested parties.

Thank you for your attention to this matter.

Very truly yours,

ALAN WM. WOLFF.

Mr. SILVERMAN. Mr. Chairman, I would like, if I may, to speak to three of the concerns of the Treasury Department that were raised in the Treasury Department's statement before you. I think some related to questions that you previously asked.

First, regarding the assurances that the wine industry was given and the fact that this was actually intended, as you know this arose out of the question of the wine gallon-proof gallon issue and whether or not the discrimination should be abolished as it subsequently was.

During the lobbying between the domestic bottlers and the importers of bottled imported distilled spirits, we were numerous times asked to take a position. We consulted Government officials and were told we were not involved. As you know, Mr. Strauss wanted to put in various implementing provisions, particularly to sooth some of the concerns of domestic bottlers whose position was not adopted by the Trade Subcommittee. One of these provisions of course was the "All in Bond" concept.

One of the other provisions put in was the question of deferring the excess tax collection period on distilled spirits for 5 additional days a year for 3 years. Now, the wine industry heard about that at the time it was in Mr. Vanik's Trade Subcommittee. We repeatedly asked through our Congressmen and directly to STR if we could also have this benefit. Mr. Corman wrote a letter to Mr. Vanik and in each case we were told that you cannot have this provision. The STR and Treasury people told us the same thing. They said you cannot have it because nothing in wine gallon-proof gallon or any of the implementing provision affects the wine industry adversely in any way.

In addition, sir, on July 9, when we discovered the situation we speak of here today, we met Congressman Coelho and myself—with Harry Lamar, and we asked Mr. Lamar if this, in fact, resulted in wine being taxed as a distilled spirit. Mr. Lamar at that time told us he did not believe that was the case, and in fact he told us it was not the case.

It was not until the following day on July 10, when the trade bill was already on the House floor that Mr. Lamar corrected his opinion. Apparently, he looked further into it and corrected his opinion of the prior day. It was at that point that Mr. Vanik made the statement that I have submitted for the record. That is one concern I would like to detail to substantiate the position of the wine industry.

On the question of triggering of the tax, as you know, an identical bill was heard in the Senate in December and then was added as an amendment to H.R. 4612.

During the hearing before Senator Byrd's committee an amendment was made that the tax would be triggered at the time the tax was paid, and the Joint Taxation Committee was very much involved in this and the staff was very cooperative and certainly we hoped that that amendment would be reflected in this bill; so that, I think, I have spoken to that concern.

In the bill itself, Treasury now makes the contention regarding the determination of the wine content in imports, I think the thing that has to be kept in mind is this: This is a credit that, true, is available to an importer. Under this bill, the burden of proof would be

on the primary importer who I may add is an American. He actually pays the tax and is subject to a basic permit, which basic permit stands to be lost if anything happens which is contrary to law.

The burden of proof is on that domestic importer to show the Treasury Department to its satisfaction that the alcohol added, for which credit is claimed actually from wine.

In addition to losing his basic permit, there are also criminal penalties, I believe section 7201 of title 26 makes it a felony to evade or defeat a tax, conviction of which is punishable by a penalty of \$10,000 or 5 years imprisonment, or both.

It is also interesting to note that the Treasury Department, as I am sure you are aware, has made a specific proposal in the ingredient labeling area to verify whether or not a substance is added or occurs naturally in an imported product by the very same certification by an authorized public official of the country of origin. This is the very same thing that is in this bill, but here we do have additional penalties involved and a primary importer who is directly concerned with losing his permit.

It is true that there is no inspection and recordkeeping. However, we submit the safeguards are such, particularly in view of the fact that Treasury has already proposed the same audit for ingredient labeling, the primary importer who is an American is involved here and it is he who gets the tax credit and who pays the tax, that the Treasury is, I think, taking a position that is very well protected. The burden on the importer of the imported product is no greater than that currently placed on the domestic producer.

We furnish what we call a rectification formula which would be as detailed as the statement of process that the importer would furnish.

In addition, there are other methods which the Treasury Department, by statute, would be authorized to implement in the form of regulation, should this not be satisfactory.

STATEMENT OF PAUL STEFAN, VICE PRESIDENT, CHARLES JACQUIN ET CIE., INC.

DR. STEFAN. I am Dr. Paul Stefan, senior vice president, production and quality control of Charles Jacquin et Cie., Inc. The Jacquin firm is America's oldest cordial producers, founded in 1844. It is an independent company, not owned by a major distiller. Our volume is approximately \$76 million per year, and we employ 300 people. We have two plants; one in Philadelphia, Pa., and one in Auburndale, Fla. We believe our volume places us in the middle range of liquor producers in the United States. Our main product line consists of cordials coming in from the cocoa area.

Over a period of many years we have successfully developed the blending of wines in the production of our cordials. We use 75,000 gallons of wine per year. While wines cost us more per yield of alcoholic content than spirits, we find the character and quality of wines in a cordial enables us to produce a tastier, better product for the consumer. In the past we had been able to offset the increased cost of using wines by the lower tax rate on them as compared to spirits. Therefore, the usage of wines enabled us to offer an excellent product at a reasonable

price. Unless House bill H.R. 5616 is passed, we will have no choice than to discontinue the use of wines as the cost to our firm would be prohibitive due to the higher tax rate. Consequently the resulting product we will be marketing will have less character than that which we currently market, and will acquire formulae adjustment using other fruit concentrates and extracts; therefore, our price to the consumer will rise.

There was an amendment to H.R. 4612, and Treasury postponed the assessment of these distilled spirits tax on wine until March 20, 1980. However, now that that deferral is no longer in effect, many rectifiers and distillers are already getting away from the use of wine. We sincerely believe that the revamping of the alcoholic beverage tax laws as a result of the GATT negotiations was designed to give parity to overseas producers of liquor to American producers. We do not feel, however, the intent of the GATT negotiations was to harm the production of cordials in the United States. The impact on a firm like ours is particularly significant as we are not a big distiller with a great deal of our product line in bourbons, Canadians, and Scotch which do not use wines.

We do not feel it fair or equitable that overseas producers of liquor should gain from the GATT negotiations and domestic producers of cordials should suffer.

We sincerely believe House bill H.R. 5616 should be passed from the standpoint of fairness to the American cordial industry as well as compliance with the spirit of the GATT negotiations. We believe House bill H.R. 5616 corrects an inadvertent oversight in the revision of alcoholic beverage laws resulting from the GATT negotiations.

Mr. ROSTENKOWSKI. Mr. Sagle is next.

STATEMENT OF ROBERT F. SAGLE, COUNSEL, THE ASSOCIATION OF AMERICAN VINTNERS

Mr. SAGLE. Mr. Chairman, I am Robert F. Sagle, partner in the firm of McDermott, Will & Emery, with a Washington office at 1101 Connecticut Avenue, N.W., 20036. I am counsel to the Association of American Vintners.

This association, Mr. Chairman, consists of 73 wineries from 19 States east of the Rocky Mountains. We are very much concerned with the sale of wine and sales do have some relationship to the amount of tax levied. We appreciate the opportunity to appear here and to support enactment of H.R. 5616.

My members are concerned that the Trade Agreements Act of 1979 suddenly encompassed a huge increase in the cost of the wine used in distilled spirits products by increasing the tax rate on such wine to the distilled spirits tax rate thus effectively eliminating the use of virtually any wine in distilled spirits products.

We believe all wine, regardless of its beverage use should be taxed as wine at a reasonable wine tax rate, so that our grape growers will be able to increase their acreage and their market should expand. Several States have provided incentives to industry to locate there; for example, Arkansas has repealed the 5-cent tax on rectified spirits and this in turn has enabled a major international producer and distribu-

tor of distilled spirits products, most of which use wine as an ingredient, to locate there.

We need this kind of opportunity throughout the eastern part of the United States, at least where we are trying to find a market for our very flavorful eastern grape types, which simply need a greater marketplace than would be possible without sales to distilled spirits processors. Eastern grapes produce a very flavorful wine and every market that can exist for such is very much welcomed.

While many of our members, large and small, might not be affected by the enactment of this legislation, all of us support the continued and increased use of wine in every legitimate way in this country at the lowest possible rate of taxation. H.R. 5616 will maintain the traditional wine tax rates on all wine regardless of its ultimate consumption use.

With our continuing requirements to increase the use of grapes and wine in this country and in international trade, we cannot believe that Congress intends to eliminate a market for American wine.

All we try to do here is to insure that there is no increase, under any circumstances, in the rate of taxation of wine, and promote the increased use of American wine in all legitimate markets. The one that has been affected by last year's amendment, will be repealed, so that we can promote the increased use of American wine in all legitimate markets. This can be particularly helpful to many small vintners and growers and we urge you to enact H.R. 5616, so that its provision will be effective January 1, 1980.

Mr. Chairman, if I may address very briefly one or two of the things that Mr. Silverman did, it is our understanding that very little wine is used in imported cordials and liquors. We feel quite confident that those cordials and liquors which are imported are not about to change their formula for a few cents or even several dollars for provision of a tax credit which their importers could get.

The flavors of the end products themselves are too well known and too important, in our view, for anyone to tamper with, and we further understand that Treasury is not really concerned with any effective revenue impact. The records to support tax credit claims which Treasury or the Bureau of Alcohol, Tobacco, and Firearms can require, we understand will be little, if any, more than are presently required for production records for products containing wine and distilled spirits today.

We would understand further that the importer who wants to file a claim for tax credit under this legislation would be required to file a supporting statement, a detailed list of all of the ingredients in his product, and show the amount and percentage of alcohol in the wine contained in it to support the claim.

Now, realistically, we suggest that few, if any, cordial producers will want to produce that kind of detail particularly when it is our experience that virtually everyone tries to protect all of the detailed ingredients in such products.

I would add to what Mr. Silverman said in this regard that we are quite sure that regulations promulgated by ATF concerning the ingredients of imports would require an affirmation by a foreign government official which could be relied upon, so that in our view the en-

forcement problems may not be as difficult as characterized by the Treasury witness. Thank you.

Mr. ROSTENKOWSKI. Mr. Thompson, you may proceed.

STATEMENT OF DANIEL R. THOMPSON, GENERAL COUNSEL, FLAVOR & EXTRACT MANUFACTURERS ASSOCIATION

Mr. THOMPSON. Mr. Chairman, my name is Daniel R. Thompson. I am a partner of the Washington law firm of Bonner, Thompson, O'Connell, Gaynes & Middlekauff. I am here as counsel for the Flavor & Extract Manufacturers Association, and my address is 900 17th Street NW., Washington, D.C.

The Flavor & Extract Manufacturers Association—FEMA—is made up of approximately 100 members who make the flavors which find their way into American foods and beverages. We are grateful at this time for the opportunity to share with you, Mr. Chairman, the views and comments of the association on H.R. 5616.

Wines and flavor materials containing alcohol are of great importance for use in blended whisky. Flavor materials are used in distilled spirits products for the purpose of wedding the distilled spirits such as bourbon with grain neutral spirits to provide the best flavoring characteristics for the beverage.

Before the Trade Agreements Act of 1979, flavor materials were effectively taxed at \$1 per proof-gallon. Under the new system, such flavor materials are effectively taxed at \$11.50 per proof-gallon. [\$1 paid by the flavor manufacturer, \$10.50 paid by the distilled spirits products manufacturer as a result of the all-in-bond system.]

Similarly, the wine was taxed at a significantly lower rate than it is under the all-in-bond system.

FEMA supports the efforts of this subcommittee to restore the pre-1980 excise tax status of wines used in distilled spirits products. H.R. 5616 is particularly well designed for solving the problem created for the wine industry by all-in-bond system.

The bill deals with only part of the problem. We believe that H.R. 5616 should be modified to restore both wines and flavor materials to their pre-1980 tax status. Our concern is substantial because flavor manufacturers have no alternative market for their products. The flavor manufacturer's product is tailored to the needs of his customer. This is especially true for the specialized segment of the flavor industry that serves the distilled spirits products industry. If the distilled spirits producer cannot afford to use the flavor manufacturer's product because of tax impact, the flavor manufacturer would be left with a specialized product that is not marketable elsewhere. Some manufacturers would likely go out of business, an unnecessary tragedy when one realizes that this effect of the all-in-bond system is inadvertent and unnecessary to the purposes of the Trade Agreements Act of 1979.

Enacting legislation to provide a tax credit for wines blended into distilled spirits products to restore their pre-1980 tax status without modifying H.R. 5616 to provide equal relief for flavor mixtures would put the flavor industry under a severe competitive disadvantage to the wine industry in the blending market.

If H.R. 5616 becomes a law without such modification, the ability of the flavor manufacturer to compete would be very seriously limited. The tax on the wine content in distilled spirits would be 17 to 67 cents per wine gallon while the tax per wine gallon of flavor materials would be \$21 to \$23. This is a ratio of approximately 1 to 135. I have stated that FEMA supports enactment of H.R. 5616 and this support is unequivocal. However, I do not believe that it is the intent of this committee to eliminate the ability of the flavor industry to compete by imposing vastly unequal tax burdens on flavors and wines. Thank you.

[The prepared statement follows:]

STATEMENT OF THE FLAVOR & EXTRACT MANUFACTURERS ASSOCIATION

I. INTRODUCTION

Mr. Chairman and other distinguished members of the Subcommittee, my name is Daniel R. Thompson, Executive Secretary of the Flavor and Extract Manufacturers Association (FEMA). FEMA is the sole national trade association of the flavor industry. Its active members, approximately 100 in number, are primarily engaged in the manufacture and sale of flavors or flavor ingredients. FEMA's active members constitute a majority of the flavor manufacturers in the United States, and manufacture a majority of the flavors and flavoring ingredients sold in the United States.

II. WINES AND FLAVOR MATERIALS WITH NONBEVERAGE ALCOHOL ARE INDISPENSABLE TO THE DISTILLED SPIRITS PRODUCT INDUSTRY

My purpose here today is to testify in support of H.R. 5616, a measure to restore the tax status of wines used in distilled spirits products to what it was before enactment of the Trade Agreements Act of 1979. Wines and flavor and extract materials containing nonbeverage alcohol are of great importance to the distilled spirits product industry for use in blended whiskey, rum and brandy. Flavoring materials are also essential in cordials, liquers and other flavored distilled spirits products. Both wine and flavor materials with nonbeverage alcohol are used as "blenders" in distilled spirits products for the purpose of "marrying" the distilled spirits such as bourbon, with grain neutral spirits to permit the best flavoring characteristics to come through. Flavor materials with nonbeverage alcohol are especially important in blending because they make it possible to control the uniformity and consistent perception of the desired flavoring characteristics with a resultant improved acceptability of the finished product to the consumer. Without judicious use of these ingredients, the proprietary nature of distilled spirits products change so that the distilled spirits products industry would suffer losses in sales.

The alcohol in both wine and flavoring materials is there by necessity. For flavoring materials used in distilled spirits products, alcohol is the best and most certain solvent available. There are relatively few solvents that are acceptable for use in food products, alcohol is one of them. Substitute solvents may not blend well with ethyl alcohol and the finished product's stability may suffer from the introduction of materials foreign to the distilled spirits product. Stability is important because distilled spirits products may remain on retail shelves, sometimes in harsh sunlight, for long periods of time. There are some flavors which will not dissolve in solvents other than alcohol. Concentrating flavors so that there is less alcohol in the finished distilled spirits product is unsatisfactory because stability can often be adversely affected.

Wine contains alcohol derived from fermentation. The alcohol cannot be removed from the wine without causing changes in the flavor characteristics and other undesirable physical changes.

In the absence of legislation to restore the pre-1980 excise tax treatment of both types of these most significant ingredients, the quality of distilled spirits products will suffer since producers will be under considerable economic pressure to alter blending recipes that have been developed and proven over many years through painstaking research. Sales of distilled spirits products will dimin-

ish unless there is relief from the all-in-bond system for both wines and flavor materials with nonbeverage alcohol.

III. PRIOR LAW

Prior to January 1, 1980, the effective date of the Trade Agreements Act of 1979, the flavor materials with nonbeverage alcohol sold to distilled spirits products manufacturers were (and still are) considered to be "nonbeverage" by the Bureau of Alcohol, Tobacco, and Firearms of the Treasury Department. Under the old system the distilled spirits product manufacturers did not pay the \$10.50 per proof gallon tax for flavor materials with nonbeverage alcohol. Instead, the flavor manufacturer paid the \$10.50 tax with a \$9.50 "drawback" or rebate from the Treasury Department. In other words, the flavor manufacturer paid a net \$1 tax and the distilled spirits producer paid no direct tax on the flavor material portion of his finished product (except for the rectifying tax described below). Separate tax consideration was given to alcohol used as a solvent or carrier of a flavor as opposed to the alcohol used in the distilled spirits product for beverage purposes.

Similarly, the wine blended into a distilled spirits product was taxed at a lower rate depending upon its alcohol content. The "true" alcohol in a batch of distilled products, that is, the alcohol not derived from the flavoring or wine content, was taxed before the addition of flavors and wine pursuant to 26 U.S.C. Chapter 51, Subchapter A. An additional 30 cents per proof gallon rectifying tax was levied on the finished product. Since January 1, 1980, under the all-in-bond system, the \$10.50 per proof gallon distilled spirits tax is imposed on the finished distilled spirits product including its wines component and flavor material component. The rectifying tax has been eliminated. In effect, under the new system, flavor materials with nonbeverage alcohol are taxed at the rate of \$11.50 per proof gallon (\$1 per proof gallon paid by the flavor manufacturer and \$10.50 paid by the distilled spirits product manufacturer) rather than the previous \$1 per proof gallon tax. The wine component is effectively taxed at \$10.50 per proof gallon, a substantial increase over the pre-1980 rate. H.R. 5616 would restore the excise tax on the wine portion of the finished distilled spirits product to what it was before 1980 by means of a credit. The Treasury Department accomplished a temporary reversion to the pre-1980 tax status of wine used in distilled spirits products through Treasury Decision ATF-64 (45 Federal Register 7528, February 1, 1980). This temporary exemption has now expired.

FEMA endorses the efforts of Congress and the Treasury Department to restore the pre-1980 excise tax status of wines used in distilled spirits products. H.R. 5616 is particularly well designed for solving the problem created for the wine blended into distilled spirits products to their previous tax status in a simple, easily administered way and results in a tax arrangement totally consistent with the way those wines were taxed before 1980.

IV. THE IMPACT OF THE ALL-IN-BOND SYSTEM ON THE FLAVOR INDUSTRY IS DELETERIOUS

FEMA is greatly troubled that similar relief for flavor mixtures with nonbeverage alcohol used in distilled spirits may not be forthcoming and therefore believes that H.R. 5616 should be amended accordingly. Our concern is substantial because, unlike wine producers, flavor manufacturers have no alternative market for their product. The flavor manufacturer's product is tailored to the needs of his customer. This is especially true for the specialized segment of the flavor industry that caters to the distilled spirits products industry. If the distilled spirits producer cannot afford to use the flavor manufacturer's product because of the serious adverse tax impact that use of the flavor would have on his finished product the flavor manufacturer is left with a specialized product that is not marketable elsewhere.

Another consequence of the impact of the increased excise tax on nonbeverage alcohol would be to force some distilled spirits producers to go to the great inconvenience of making their own flavors in their own bonded facility. These flavors would not incorporate the high degree of sophistication which flavor manufacturers are able to achieve due to their long experience and utilization of experts specializing in these areas.

In some cases, where a very large percentage of a flavor manufacturer's total business arises from trade with the distilled spirits products industry, the loss of market resulting from the new tax impact of the use of flavor mixtures will force him out of business. This eliminates jobs and causes a hardship to all flavor manufacturers who have been selling their products to the distilled spirits industry over the years. This is an unnecessary tragedy when one realizes that this effect of the all-in-bond system is inadvertent and unnecessary to the purposes of the Trade Agreements Act of 1979.

For the reasons I have already described, it is not feasible to minimize the tax impact of the use of flavor mixtures with nonbeverage alcohol by concentrating the flavor or using a substitute solvent. Yet distilled spirits products manufacturers may be forced to take these steps.

Enacting legislation to provide a tax credit for wines blended into distilled spirits products to restore their tax status to what it was before 1980 without amending H.R. 5616 to provide a counterpart measure for flavor materials would put the flavor industry under a severe competitive disadvantage to the wine industry in the blending market. Wines are already considerably less expensive than blenders produced by flavor manufacturers, however, flavor manufacturers are able to compete in the blending market because their products contain combinations of natural ingredients which in many cases permit greater versatility in blending qualities. The distilled spirits product manufacturer will often use both wine and flavoring materials in order to achieve the best of both worlds. If H.R. 5616 becomes law without being modified, and there is no similar relief for flavor materials with nonbeverage alcohol, the ability of flavor materials to compete with wines in the distilled spirits products market will be eliminated. The tax on the wine content in distilled spirits would be 17 cents per wine gallon while the tax per wine gallon of flavoring materials with nonbeverage alcohol would be \$21 to \$23. This is a ratio of approximately 1 to 135. I have stated that FEMA supports enactment of H.R. 5616 and this support is unequivocal. Nevertheless, the bill solves only half of the problem created by the all-in-bond system, and we would like to see it modified to deal with the entire problem. I do not believe that it is the intent of Congress to impose inequitable tax treatment upon two extremely important classes of ingredient used in the process of manufacturing blended whiskey, cordials, and other distilled spirits products. Nor do I believe that Congress considers a heavy excise tax on these ingredients justified, when the alcohol in wine is there due to wine's very nature, and the nonbeverage alcohol in the flavor mixture is there as a necessary solvent. A restoration of the pre-1980 excise tax treatment on both of those most significant types of ingredients will resolve these problems.

V. THE HARSH IMPACT OF THE ALL-IN-BOND SYSTEM WAS INADVERTENT AND IS NOT ESSENTIAL FOR ACHIEVEMENT OF THE PURPOSES OF THE TRADE AGREEMENTS ACT OF 1979

I would like to draw your attention momentarily to the testimony of Senator Cranston on S. 1913, the companion bill to H.R. 5616, before the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance on December 19, 1979. Senator Cranston stated that a purpose of the Trade Agreements Act of 1979 was to equalize the tax treatment of domestic and foreign-produced distilled spirits and that the severe adverse impact of the all-in-bond system on the market for domestic wines in blending distilled spirits was an inadvertent consequence of the enactment of the law.¹ Congressman Coelho, who introduced H.R. 5616, testified to the same effect.²

The intent of H.R. 5616 is to undo the inadvertent consequence referred to during the course of the hearings on S. 1913. The hardship visited upon the flavor industry by the all-in-bond system is no less inadvertent, although it is, in FEMA's opinion, infinitely more severe.

A provision to relieve the flavor industry from the severe impacts of the all-in-bond system would not frustrate the intent of the Trade Agreements Act to equalize the tax treatment of domestic and foreign produced distilled spirits. Just as H.R. 5616 applies to both domestic and foreign wine producers, an amend-

¹ Excise Tax Treatment for Wine and Distilled Spirits: Hearings on S. 1913 Before the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance; 96th Congress, 1st session 7, 8 (1979) (statement of Senator Cranston).

² Id. at 9.

ment providing a credit for both domestic and foreign flavor producers could be drafted. Because FEMA is so concerned about the destructive consequences of the present all-in-bond system to the flavor industry, I would like to express my willingness to work with the committee staff to assist in the development of legislation to restore equity to the excise tax treatment of flavor mixtures with nonbeverage alcohol. Such a measure could, like H.R. 5616, be a simple solution that would not impose an administrative burden on the Treasury Department. I would like to submit for the record a proposed amendment to H.R. 5616 that would deal with the problems created for the flavor industry by the all-in-bond system.

VI. CONCLUSION

I would like to conclude by summarizing the main points I have tried to make today. FEMA supports H.R. 5616 as the first step in returning the tax treatment of distilled spirits products ingredients to what it was before the advent of the all-in-bond system. FEMA is seriously concerned that the bill addresses only half of the problem created by the all-in-bond system and would like to see H.R. 5616 modified to resolve the entire problem. The flavor industry urgently needs relief similar to that which would be provided to the wine industry by H.R. 5616 because: (1) producers of flavors for distilled spirits products manufacturers have no alternative market; (2) it is not feasible to minimize the tax impact of flavor use in distilled spirits products by concentrating flavors or substituting solvents; (3) without relief, economic forces may stimulate distilled spirits products manufacturers to alter their formulas and, in so doing, decrease the quality of their finished product and consumer acceptance of those products; and (4) amending H.R. 5616 (or enacting separate new legislation) to return the tax status of flavoring and extract materials containing nonbeverage alcohol for introduction into distilled spirits products to what it was before 1980 would eliminate the crippling tax and competitive inequities which would occur if H.R. 5616 were passed unamended (or no new legislation were enacted). H.R. 5616 amended to provide relief for the flavor industry would not frustrate the purposes of the Trade Agreements Act of 1979.

That concludes my prepared statement, Mr. Chairman, I would be happy to answer any questions.

ABBREVIATED STATEMENT FOR ORAL PRESENTATION

Mr. Chairman and other distinguished members of the Subcommittee, my name is Daniel R. Thompson, Executive Secretary of the Flavor and Extract Manufacturers Association (FEMA). FEMA is the sole national trade association of the flavor industry. I would like to submit my formal statement for the record and briefly summarize my remarks.

My purpose here today is to testify in support of H.R. 5616, a measure to restore the tax status of wines used in distilled spirits products to what it was before enactment of the Trade Agreements Act of 1979. Wines and flavor and extract materials containing nonbeverage alcohol are of great importance to the distilled spirits product industry for use in blended whiskey, rum, and brandy. Flavoring materials are also essential in cordials, liquors and other flavored distilled spirits products. Both wine and flavor materials with nonbeverage alcohol are used as "blenders" in distilled spirits products for the purpose of "marrying" the distilled spirits such as bourbon, with grain neutral spirits to permit the best flavoring characteristics to come through. Flavor materials with nonbeverage alcohol are especially important in blending because they assure the consistency and therefore acceptability of the finished product to the consumer. Without these ingredients, the distilled spirits products industry would suffer losses in sales.

The alcohol in both wine and flavoring materials is there by necessity. For flavor materials used in distilled spirits products, alcohol is the best and most certain solvent available. It is not feasible to attempt to minimize the tax impact by concentrating the flavor or by using substitute solvents. Some flavors will not dissolve in solvents other than alcohol. Concentration of flavors or use of substitute solvents can adversely affect the stability of the finished distilled spirits product. Stability is important because distilled spirits products may remain on retail shelves for long periods of time, sometimes in harsh sunlight.

Wine contains alcohol derived from fermentation. The alcohol cannot be removed from the wine without causing flavor changes and other undesirable physical changes.

In the absence of legislation to restore the pre-1980 excise tax treatment of both types of these most significant ingredients, the quality of distilled spirits products will suffer since producers will be under considerable economic pressure to alter blending recipes that have been developed and proven over many years through painstaking research. Sales of distilled spirits products will diminish unless there is relief from the all-in-bond system for both wines and flavor materials with nonbeverage alcohol.

Under prior law, flavor materials with nonbeverage alcohol were effectively taxed at \$1 per proof gallon. Under the new system, such flavor materials are effectively taxed at \$11.50 per proof gallon. (\$1 paid by the flavor manufacturer, \$10.50 paid by the distilled spirits products manufacturer as a result of the all-in-bond system.)

Similarly, wine was taxed at a significantly lower rate (depending upon its alcoholic content) than under the all-in-bond system.

FEMA supports the efforts of Congress to restore the pre-1980 excise tax status of wines used in distilled spirits products. H.R. 5616 is particularly well designed for solving the problem created for the wine industry by the all-in-bond system. It restores wines blended into distilled spirits products to their previous tax status in a simple, easily administered way totally consistent with the way those wines were taxed before 1980.

FEMA is troubled that similar relief for nonbeverage alcohol flavor mixtures used in distilled spirits products may not be forthcoming and therefore believes that H.R. 5616 be modified accordingly. Our concern is substantial because, unlike wine producers, flavor manufacturers have no alternative market for their product. The flavor manufacturer's product is tailored to the needs of his customer. This is especially true for the specialized segment of the flavor industry that caters to the distilled spirits products industry. If the distilled spirits producer cannot afford to use the flavor manufacturer's product because of the tax impact, the flavor manufacturer is often left with a specialized product that is not marketable elsewhere. In all likelihood, he goes out of business, an unnecessary tragedy when one realizes that this effect of the all-in-bond system is inadvertent and unnecessary to the purposes of the Trade Agreements Act of 1979.

Enacting legislation to provide a tax credit for wines blended into distilled spirits products to restore their tax status to what it was before 1980 without modifying H.R. 5616 to provide a counterpart measure for flavor mixtures would put the flavor industry under a severe competitive disadvantage to the wine industry in the blending market. Wines are already considerably less expensive than blenders produced by flavor manufacturers, however flavor manufacturers are able to compete with wines in the blending market because of their products' superior blending qualities. If H.R. 5616 becomes law without modification, and there is no similar relief for flavor materials with nonbeverage alcohol this ability to compete would be eliminated. The tax on the wine content in distilled spirits would be 17 cents per wine gallon while the tax per wine gallon of flavor materials with nonbeverage alcohol would be \$21 to \$23. This is a ratio of approximately 1 to 135. I have stated that FEMA supports enactment of H.R. 5616 and this support is unequivocal. Nevertheless the bill solves only half of the problem created by the all-in-bond system, and we would like to see it modified to resolve the entire problem. I do not believe that it is the intent of Congress to eliminate the ability of the flavor industry to compete in the distilled spirits blending market.

I would like to draw your attention momentarily to the testimony of Senator Cranston on S. 1913, the companion bill to H.R. 5616, before the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance on December 19, 1979. Senator Cranston stated that a purpose of the Trade Agreements Act of 1979 was to equalize the tax treatment of domestic and foreign-produced distilled spirits products and that the severe adverse impact of the all-in-bond system on the market for domestic wines in blending distilled spirits was an inadvertent consequence of the enactment of the law. Congressman Coelho, the sponsor of H.R. 5616, testified to the same effect.

The intent of H.R. 5616 is to undo the inadvertent consequence referred to in the Senate hearings. The hardship visited upon the flavor industry by the all-in-bond system is no less inadvertent, although it is, in FEMA's opinion, infinitely more severe.

A provision to relieve the flavor industry from the severe impacts of the all-in-bond system would not frustrate the intent of the Trade Agreements Act to

equalize the tax treatment of domestic and foreign produced distilled spirits products. An amendment providing a credit for both domestic and foreign flavor producers could be drafted. Because FEMA is so concerned about the destructive consequences of the present all-in-bond system to the flavor industry, I would like to express my willingness to work with the committee staff to assist in the development of provisions for flavor materials like those now embodied in H.R. 5616 for wines. Such a measure could, like H.R. 5616, provide a simple, easy to administer way of returning the tax status of flavor mixtures with non-beverage alcohol to what it was before the all-in-bond system. I would like to submit for the record a proposed amendment to H.R. 5616 that would deal with the problem created for the flavor industry by the all-in-bond system.

I would like to conclude by summarizing the main points I have tried to make today. FEMA supports H.R. 5616 as the first step in returning the tax treatment of distilled spirits products ingredients to what it was before the advent of the all-in-bond system. FEMA is seriously concerned that the bill addresses only half of the problem and would like to see it modified to deal with the entire problem. The flavor industry urgently needs relief similar to that which would be provided to the wine industry by H.R. 5616 because: (1) producers of flavors for distilled spirits products manufacturers have no alternative market; (2) it is not feasible to minimize the tax impact of flavor use in distilled spirits products by concentrating flavors or substituting solvents; (3) without relief, economic forces may stimulate distilled spirits products manufacturers to alter their formulas and, in so doing, decrease the quality of their finished product and consumer acceptance of those products; and (4) amending H.R. 5616 (or enacting separate new legislation) to return the tax status of flavoring and extract materials containing nonbeverage alcohol for introduction into distilled spirits products to what it was before 1980 would eliminate the crippling tax and competitive inequities which would occur if H.R. 5616 were passed unamended (or no new legislation were enacted). H.R. 5616 amended to provide relief for flavor industry would not frustrate the purposes of the Trade Agreements Act of 1979.

That concludes my prepared statement, Mr. Chairman; I would be happy to answer any questions.

Mr. ROSTENKOWSKI. Thank you very much.

Mr. Thompson, do you know of any other liquid flavor manufacturer other than the extract industry that could also be put at a disadvantage by the passage of this legislation with the flavor and extract manufacturers included in it? I am just wondering if there is any other industry or any other liquid manufacturers that any of you could think of that would be put at an unfair disadvantage.

Mr. THOMPSON. I know of none, and we represent the entire flavor industry in the United States.

Mr. ROSTENKOWSKI. What do you think, Mr. Silverman?

Mr. SILVERMAN. I know of none at all.

Mr. ROSTENKOWSKI. I served on the Trade Subcommittee and I am quite aware of the situation that took place in our trade negotiations. I was one of those who actively participated in the wine gallon-proof debate. I certainly feel that this is a justifiable piece of legislation.

We will try to move this legislation as fast as we possibly can and I am sure the subcommittee will be most cooperative. Thank you.

Next is Mr. Chase, Mr. Ams, Mr. Padwe, and Mr. Clevenger.

We welcome you. We are appreciative of your joining us and creating, I hope, an atmosphere for passage of this legislation. I would like at the outset to suggest to you that you identify yourselves and go into your testimony.

Mr. Chase, if you would like to lead off, the subcommittee is ready to accept your testimony.

**STATEMENT OF SAMUEL M. CHASE, JR., CHAIRMAN, LEGISLATIVE
AD HOC SUBCOMMITTEE ON REAL ESTATE SECURITIES, NATIONAL
ASSOCIATION OF REALTORS**

Mr. CHASE. Thank you, Mr. Chairman.

My name is Samuel M. Chase, Jr., and I am a realtor from the city of Zionsville, Ind., and the address is 90 Boone Woods Way.

I have the honor of serving as chairman of the Realtors Legislative Ad Hoc Subcommittee on Real Estate Partnerships and Securities, and also as a member of their standing Legislative Subcommittee on Federal Taxation.

I am accompanied by Mr. John Ams, who is our Staff Director of Tax Programs in our Government Affairs Division.

We certainly appreciate the opportunity to be here today to comment on the two proposed bills that are of utmost interest and concern to our industry, H.R. 6883, the Installment Sales Revision Act of 1980, and H.R. 5729.

In the interest of time and since we have had the opportunity to listen to several hours of discussion on the Installment Sales Revision Act, I think that I might summarize the written statements that shall be provided. We are very pleased at the impact of the act and support the bill's revision of the method for obtaining installment sales treatment and specifically the inclusion of the sales of real property based upon contingent selling prices, a natural and long-term commonplace transaction in the real estate industry.

In addition, in the interest of brevity, we would agree with the testimony of Mr. Murdoch of the Small Business Council of America as they relate to related party sales and the concepts thereunder.

I will isolate the remainder of my remarks to what I believe is a more fundamental and critical tax issue, and also a fundamental economic issue, that is House bill 5729, which, as we have heard this morning, is supported by the Department of the Treasury, and would allow startup costs as defined to be amortized over the first 5 years of a new business' life, starting when a taxpayer begins business. To be specific, there is a history since 1976 of escalating difficulty between taxpayers and Internal Revenue Service over this and several other aspects relate to so-called startup costs or preopening expenses.

Much of this testimony was heard in great detail in 1973, 1974, and 1975, culminating in the Tax Reform Act of 1976, and the requirement that construction period interest and taxes be capitalized. That same Congress rejected the idea of a preopening expense not being a deductible item. Hence, we support the general concept in the bill but we ask that this subcommittee and the Congress not act precipitously on it due to various concerns that we have.

First, there is an administrative hearing scheduled to take place next month which will address several of the issues associated with this bill. On May 21 the Internal Revenue Service has scheduled a hearing on auditing regulations proposed on January 11, 1980, purporting to conform regulations under sections 707 and 709 of the code.

The administrative hearings related to section 709 will be concerned with what we believe is the key major issue, and that is when does a new business begin.

I might stop here to amplify with a simple example. Each time a new real estate project is started in the country, the legal manner in which it is started is the creation of a new business entity. As this bill before you addresses the amortization of expenses related to that same issue, but without resolving the critical question of when a business is deemed to have begun, we have serious reservations concerning potential IRS interpretation that the definition "functioning as a going concern," involves the creation of current gross income, a position they have taken under audit procedures for the past 3 to 4 years. This would be precisely their erroneous position of the last 3 years.

In our view a business entity like a partnership, subchapter S corporation, or general business corporation formed to finance the development and construction of improvements to real property to be held for rent is a going concern at the time it begins activities relative to the acquisition of operating assets necessary to the type of business contemplated.

A taxpayer should be considered as being a business certainly well before receiving any rental income when most of the time it takes some 2 to 3 years to build a project.

During that 2- to 3-year period there are various revenues to the project such as income from loans, salaries being paid to construction workers, sales taxes, et cetera, and we believe that the current IRS position as to when the trade or business begins to be erroneous.

We would suggest that a more appropriate concept of defining when a trade or business begins is the point at which it has advanced as to the extent necessary to establish the nature of business operations in lieu of a functioning, going concern. Making the determination about the beginning of the business involves a very complex set of issues, especially if the business starts in the form of a partnership or general business corporation on every project that begins construction in our country is because of this precise issue that every individual project is a new business entity. The IRS has utilized this to have at this point literally several thousands of real property partnerships under audit.

Another critical issue is at what point do the expenses incurred by the founding partners or corporate shareholders become expenses of the partnership. Further, what must a partnership or corporation do in order to begin business? Can we put up a sign and advertise or can we have a party announcing the opening of a project, or can you create various insurance policies and pay for them?

Can you hire attorneys and pay accountants and so on? All of these issues, we hope, will be before the IRS hearings next month. Thus we ask that we not rush to consideration of this bill until some of these fundamental economic and tax answers become clearer through the IRS hearing procedure.

Also, and very important, there is a case in the Court of Claims where a decision is pending which may clarify the definition of a beginning of business. We reserve the right to appear before you to seek a legislative answer or an amendment to the bill if clarity cannot be obtained through this case and/or the IRS hearings.

We also suggest as an economic issue, as well as a tax issue, that the way to help the development of rental housing in the country, more

office construction and thus lower rates in a proper balance of supply and demand, is not to continue to permit the IRS position of capitalizing these items but to continue to permit the historical practice of the expensing of these startup costs rather than spreading them over the first 5 years.

The economics of attempting to pay for these in cash and not being able to expense them has come to the point where it is not feasible any longer to produce rental housing of a nonsubsidized nature.

Asking the investor to carry the cash burden of the startup costs for 5 years hardly seems the best way to encourage entrepreneurs to create housing, office buildings, and industrial parks as a result of the capital formation process.

Finally, we strongly feel that partnerships should be accorded the same tax treatment as corporations in this important area. We urge that you seriously consider that taxpayers should not be discriminated against by the nature of their entity, that is, whether they are a trust, a general business corporation or subchapter S corporation or partnership. In fact, for the partnership to be discriminated against takes away the primary business entity vehicle available to the small businessman today in arranging his business affairs to build projects.

Thus we would ask that we not legislate distinctions based solely on whether the taxpayer chooses to do business as a proprietorship, partnership, or corporation. We do not think this was ever intended by the Congress but the Internal Revenue Service over the past year since the Tax Reform Act of 1976 has seen fit on an administrative basis to tax the partnership entity on a continuing ongoing nature.

We appreciate this opportunity to respectfully come before you and submit our written testimony in its full context, and we would be glad to answer any questions to clarify it.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS

My name is Samuel M. Chase, Jr. I am a realtor from Zionsville, Indiana and Chairman of the realtors Legislative Ad Hoc Subcommittee on Real Estate Securities. I am also a member of the Realtors Legislative Subcommittee on Federal Taxation. I am here representing over 700,000 members of the National Association of Realtors. Accompanying me today is John G. Ams, Director of Tax Programs in the Government Affairs Division of the National Association of Realtors. We appreciate the opportunity to appear here today to comment on two proposed bills that are of utmost interest and concern to the real estate industry, H.R. 6883, the Installment Sales Revision Act of 1980 and H.R. 5720.

SUMMARY OF POSITION

The Association is generally in support of efforts made to simplify and streamline the Internal Revenue Code. The Installment Sales Revision Act of 1980 would make much needed changes in a Code section of particular value to transferees of real property and we commend the sponsors of H.R. 6883 for their efforts, including the Chairman of this Subcommittee, Mr. Rostenkowski.

The National Association of Realtors particularly supports the revisions made by H.R. 6883 with respect to sales for a contingent selling price, the method for obtaining installment sales treatment and the receipt of like kind property. Each of these changes is necessary in order to allow the installment sale provision to operate free of the complexities inherent in the present provision, but in recognition of the practices in the marketplace. Certainly, as practitioners in the real estate industry we have long sought recognition of the fact that contingent selling prices are common and often necessary.

We are also in support of the revised related party sales provisions, however, we remain concerned that recognition of gain by the related party seller may be triggered by events that are completely out of his control. We understand the administrative problems inherent in determining whether a related party transaction is bona fide but believe that any such administrative problem is outweighed by the need for equitable treatment for related party transferors. Consequently, we support expanding this provision in the bill so as to allow related party installment sales, without the bill's two year rule, unless the transaction has no economic substance.

With respect to H.R. 5729, we support the approach taken by the bill but request that Congress not act on this proposed legislation until several of the issues involved in the area of pre-opening expenses are addressed in a pending court case and as part of an IRS administrative hearing in May.

Both the court case, *Blitzer v. United States*, currently pending in the Court of Claims, and the IRS hearing involve the question: When does a business begin? H.R. 5729 addresses the amortization of expenses related to that same issue, but without resolving the critical question about when a business is deemed to have begun. Congressional action on this bill absent a resolution of this question would be inappropriate and we urge the Committee to delay further consideration of this matter.

H.R. 6863—THE INSTALLMENT SALES REVISION ACT OF 1980

We are pleased to testify today in support of the Installment Sales Revision Act of 1980 and commend the Committee for continuing its efforts to further simplify some of the more complex provisions of the Internal Revenue Code. It is especially appropriate that Congress consider revision of the installment sales rules during this time of economic difficulty since the revised rules will present buyers and sellers a simplified alternative method of transferring property rather than the complex rules that presently exist.

While this Association supports the revised bill, we do have some concerns and will proceed with a section by section discussion of the major revisions made by the bill.

Election of installment sale treatment

The National Association of Realtors supports the bill's revision of the method for obtaining installment sales treatment. In many cases, taxpayers under current law are unaware of the benefits accorded by the installment sale method, even if the transaction would clearly be a qualifying sale. Further, we support this provision because it would reduce the paperwork burden for the many taxpayers who do elect installment sale treatment every year.

Sales for a contingent selling price

Sales of real property based on a contingent selling price have long been commonplace in the real estate industry. Typical examples include sales of commercial space based in part on the amount of future leasehold income from the property, sales of retail space based in part on the amount of sales volume, and so on. In many cases, sales of these types of property must be made on the basis of a contingent selling price since the value of the property is derived entirely from future income that cannot be determined on the date of the sale. Unfortunately, such sales have not qualified for the installment method despite the obvious need for the contingency.

We support the bill for making this much needed change and trust that the regulations that would be promulgated would recognize the many types of contingencies on which a selling price may be based.

Related party sales

While we strongly support the concept that installment sales between related parties must be allowed, we remain concerned that, even as revised by H.R. 6863, the related party seller may face serious tax consequences brought about through no fault of his or her own. Specifically, I am referring to the situation where the related party purchaser, as a result of economic circumstances unrelated to the installment sale, finds that the property must be sold within two years of the date of the installment sale. In this event, the related party seller must pay tax even though he may have had no control over the resale of the property by the related party purchaser. We are hard pressed to find any other

Code section that imposes tax on one individual solely as a result of an unrelated action by another individual.

To remedy this situation, installment sale treatment should be allowed between related parties unless the transaction is a sham, even if economic circumstances dictate that the property must be resold within the two year period mentioned in the bill.

Nevertheless, we applaud the bill's recognition of the fact that related party transactions should not automatically be disqualified from favorable tax treatment merely because the parties happen to be related. We would welcome such recognition in other areas as well. For example, the so-called "vacation home" rules preclude the owner of any rental unit from deducting expenses related to that unit, even though a fair rental is paid, merely because the renters are related to the owner.

Current law limits the allowable deductions attributable to the rental of any residence if the taxpayer or his relatives personally use the home in excess of a specified minimum period of time during the taxable year. There is no problem when this rule is applied to the vacation home situation envisioned by Congress. But it is a serious problem when applied to a residence owned by the taxpayer and rented to a relative at fair market value even though the property is not a vacation home. For example, if a taxpayer owns rental property which is rented to complete strangers, he is entitled to all appropriate deductions. If the taxpayer rents the same property at the same rent to his or her parents, the same tax rules should apply. Unfortunately, that is not the case.

The National Association of Realtors opposes such discrimination and is certainly willing to work with this Committee to remove this onerous provision and begin to deal more equitably with related party transactions, along the lines H.R. 6883 would establish in the installment sales area.

H.R. 5729

Congressman Conable has introduced a bill, H.R. 5729, supported by the Department of the Treasury, which would cause startup costs, as defined, to be amortized over the first five years of a new business' life.

We welcome Congressional review of these issues for our members who represent owners of investment properties, or who own or sell interests in real estate partnerships. There is a history of difficulties between taxpayers and the Internal Revenue Service over this and several other aspects related to startup costs, or pre-opening expenses. While we support the general approach taken by the bill, we ask that Congress not act precipitously on this bill. First, there is an administrative hearing scheduled to take place next month which involves several of the issues associated with the bill. On May 21, IRS has scheduled a hearing on its regulations proposed on January 11, 1980 (LR-266-76) purporting to conform regulations under sections 707 and 709 to section 213(b) of the Tax Reform Act.

These administrative hearings relative to Section 709 will be concerned with a major issue: When does a new business begin? The bill before you addresses the amortization of expenses related to that same issue, but without resolving the critical question about when a business is deemed to have begun. We have serious reservations concerning any interpretation that "functioning as a going concern" necessarily involves the creation of current gross income. This appears to be precisely the erroneous position taken by the Treasury Department and the IRS on this matter. It is our view, however, that a partnership formed to finance the development and construction of improvements to property to be held for rent is a going concern. It should be considered as being in business well before receiving any rental income for the use of the building the partnership was formed to construct. We suggest relying upon the more appropriately defined concept of when a trade or business has undertaken activities to the extent necessary to establish the nature of business operations in lieu of "functioning as a going concern."

Making the determination about the beginning of a business involves a very complex set of issues, especially if the business starts in the form of partnership. At what point do the expenses incurred by the founding partners become expenses of the partnership? There seems to be some unanimity of opinion that the mere filing of corporate papers, or the partnership agreement, is not sufficient to demonstrate the beginning of a business. There is less than unanimity about

what else must take place to determine that beginning point. Some of these issues will be before the IRS next month.

We ask Congress not to rush consideration of this bill until some answers to those critical questions become clearer through the IRS hearing procedure. Also, in the real estate area, there is a case¹ where a decision is pending which may clarify the definition of a beginning of business. We reserve the right to appear before you to seek a legislative answer if clarity cannot be obtained otherwise.

We also suggest that a modest, but important, way to help the development of more housing is to permit the immediate expensing of all startup costs rather than spreading them over the first five years. Asking the investor to carry the cash flow burden of startup costs for five years hardly seems the best way to encourage entrepreneurs to create more housing as part of the capital formation process.

Finally, we feel strongly that partnerships should be accorded the same treatment as corporations in this important area and urge Congress to treat taxpayers in the same manner, and not legislate distinctions based solely on whether the taxpayer chooses to do business as a proprietorship, partnership or corporation.

CONCLUSION

In conclusion, the National Association of Realtors strongly supports the Installment Sales Revision Act of 1980 and urges this Committee to favorably report the bill to the full Ways and Means Committee. We would also urge the Committee to work to resolve the vacation home rules problem outlined previously.

While we endorse the objectives of H.R. 5729, we ask that more consideration be given to the impact of this bill in light of pending administrative hearings and court cases.

The National Association of Realtors is comprised of more than 1,806 local boards of realtors located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 756,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Officers are: Ralph Pritchard, President, Oak Brook, Illinois; John R. Wood, First Vice President, Naples, Florida; James L. Helsel, Treasurer, Harrisburg, Pennsylvania.

The Chief Executive Officer is Jack Carlson, Executive Vice President and Chief Economist. Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington Office is located at 925 15th Street N.W., Washington, D.C. 20005. Telephone 202-637-6800.

STATEMENT OF GERALD W. PADWE, ASSOCIATE NATIONAL DIRECTOR, TAX SERVICES, TOUCHE ROSS & CO.

Mr. PADWE. I am Gerald Padwe, associate national tax director for the public accounting firm of Touche Ross & Co. My address is 1900 M Street N.W., Washington, D.C.

On this day when Ralph Nader is celebrating Big Business Day here in Washington and elsewhere, my comments to you concern a bill which, while it will be helpful to big business, is really aimed at aiding small businesses; namely, H.R. 5729, permitting amortization of startup expenditures.

The problems of starting up and creating a new business are manyfold. Many new businesses fail each year, some because they can not overcome the high costs of starting up. Some proposed new businesses

¹ *Blitzer v. United States* (Court of Claims No. 476-76).

never even get past the investigation stage, as they find there will not be demand of market for the new product or service. Unfortunately, our present tax laws add to this problem. They penalize entrepreneurship and discourage investing and starting up new businesses, by denying tax benefits for the costs incurred before the venture becomes a going concern.

In order to obtain a current deduction for various expenses, the entrepreneur has to be "carrying on" a trade or business, and pre-opening expenses have been held by many courts and by the IRS not to qualify as "carrying on" such trade. They become, therefore, capitalized costs not currently deductible but subject to depreciation or amortization. However, since the costs involve the development of an asset which is the business itself; and since the business does not have per se, a determinable life, depreciation or amortization is also not available for these costs. In other words, we have a Catch-22 situation.

Even if the new venture is abandoned before starting up, the individual entrepreneur will probably not be able to get a tax loss for his costs, since the transaction will not be considered by IRS and the courts to be one "entered into for profit." Corporations, probably though not always, will be able to write off their investigatory costs as they have certain options that are not available for individuals.

An interesting point is that the same costs which are not deductible in starting up a new business become deductible once the business has reached going concern status. Then those same types of costs, not deductible or depreciable to the preoperating venture, become deductible under our tax laws. Thus, our tax policy currently warns an entrepreneur who is interested in investing and starting a new business or a new economic entity: You will have to finance all of these costs with after-tax dollars, but just as soon as you can demonstrate you have become a going concern, then we will let you finance the identical types of costs with pretax dollars. In our judgment, this is an excellent illustration of a cart-before-horse policy.

An additional problem, Mr. Chairman, is that the same entrepreneurs who are being disadvantaged by our tax laws today are the very ones who are least likely to have access to capital or debt markets, because they are new businesses, thus finding themselves at a financial disadvantage on all sides. The policy seems backward and inappropriate, particularly at a time when the administration is trying to find ways to aid small business—witness, for example, the White House Conference on Small Business held earlier this year.

H.R. 5729, and its companion bill on the Senate side, S. 1638, is a very good approach to the problem and we believe merits your support. The bill is not, as was stated earlier this morning about the installment sales bill, a perfect bill. For example, it does not deal with the problem of the abandoned business venture since, in order for startup costs to be amortized there must be an ongoing business, deriving revenues against which to amortize these costs. However, there are other possibilities in the Tax Code today to deal with the abandoned business venture: While they require some relatively sophisticated tax planning before investigation of the new venture begins, at least they are available. Accordingly, we do not feel that the emphasis in H.R. 5729 on the going concern is inappropriate.

We are delighted that Treasury supports the bill, as I hope you are. Frankly, I am not used to being all that often in view of the comments I will make as to this bill's natural constituency, on the same side of an issue as Treasury, but I am very pleased that Treasury is supporting Congressman Conable's proposal.

We do suggest that the bill be clarified to permit a deduction, not only for ordinary and necessary "expenses" relating to startup costs, (as is presently in the bill), but also for depreciation or amortization costs that would be included in bona fide preoperating costs but could conceivably be disallowed under other tax concepts, which we spell out, Mr. Chairman, in our written statement. Those costs are just as much a part of bona fide preopening expenses as are the ordinary and necessary expenses presently described in the bill, and they should be subject to the new section 193 of H.R. 5729.

Finally, we hope that Congress can see the wisdom of this bill without the need for concerted lobbying efforts. By definition, the bill affects businesses that are not yet in existence so you can understand why there may not be a strong vocal constituency in favor of the bill. For this very same reason, I note that the Joint Committee staff pamphlet on today's hearings on this bill points out that the staff cannot produce a revenue estimate since there is no way to predict the number of businesses that may go into operation over the next number of years.

Note also the fact that only three people have asked to testify on this bill today, another indication I believe that this is the kind of bill that isn't likely to attract a strong vocal constituency. In summary, then, H.R. 5729 is a bill on which Congress should act because it is the right thing to do rather than because there is pressure to do so.

Thank you, Mr. Chairman. I appreciate the opportunity to present our views to you.

[The prepared statement follows:]

STATEMENT OF GERALD W. PADWE, ASSOCIATE NATIONAL DIRECTOR—TAX SERVICES, TOUCHE ROSS & CO.

Mr. Chairman and members of this distinguished committee, my name is Gerald W. Padwe, and I am Associate National Director—Tax Services for the international public accounting firm of Touche Ross & Co. I appreciate the opportunity today to put before you our views supporting H.R. 5729, a bill which would permit the amortization of pre-operating costs by a new business over a period of not less than 60 months (except in the event of the business' liquidation) after it becomes a going concern. We believe the measure warrants your support and would urge its passage—perhaps with one or two language clarifications which we will discuss.

BACKGROUND OF THE PROBLEM

It is an unfortunate fact of business life that present tax rules operate as a substantial disincentive to entrepreneurship in their treatment of expenditures (both current and capital) incurred before a new business actually gets past its pre-opening stage and becomes a going concern. Before a business can start operations, it first becomes necessary to investigate its feasibility and likely success: that decision requires looking into markets, business prospect, capital and financing availability, the availability of human resources to manage and operate the business, etc. After the decision has been made to begin a new business venture, there is a period of time requiring heavy expenditures while the business is in a "start-up" phase, but before it can be said to have become a going concern. Costs incurred during this pre-opening phase include rental of facilities or depreciation on newly acquired owned facilities, salaries of the staff getting the business

organized, legal and accounting advice, maintenance, utilities, property taxes, insurance, etc. These costs would all be deductible if the venture was actually operating—but not while it is still in pre-opening status.

Today's tax rules, as developed judicially and statutorily, permit only very limited deductibility of any of these costs—ever—or at least, until the time the business is terminated, which may be many years down the road. The basic reasons for this are twofold: first, while taxpayers are entitled to deduct all ordinary and necessary expenses incurred in carrying on a trade or business, that language in our tax laws has been consistently interpreted to permit only expenses incurred after the business commences operations as a going concern to qualify for deduction. Expenses which would qualify but for the fact they are incurred prior to going concern status, become—in tax terms—"chargeable to capital account" and not currently deductible; or, in accounting terms, a deferred charge in the nature of an intangible asset. Second, while such deferred charges are technically eligible for amortization under present tax law, such amortization must be over a readily determinable life; since a business, by definition, almost never has a determinable life (it may last for three months, it may go on for 100 years), amortization is not permitted since the life of the intangible asset is not determinable.

The result of these two general concepts is that most pre-operating expenses remain on the business' tax books as a deferred charge available for tax relief only at the termination of the business as a going concern. However, the expenditures are incurred at a time when entrepreneurs most strongly need the tax benefits they can bestow. Our tax policies seem backwards when we tell new business venturers that virtually all expenses of looking into and starting-up a new business must be paid for with after-tax dollars, although once the business does begin those same expenses may be paid with pre-tax dollars.

By the nature of the problem, the tax treatment of pre-operating expenses is usually a small business issue. While big business is certainly not exempt from attack by Internal Revenue as to deductibility of such costs (retail chains opening a new branch in a new market area would be an example), the larger, and likely more long established, business will often be able to obtain tax relief because the expenses of looking into a new line of business are so closely tied, economically, to the existing business. It is, however, the small business person and the entrepreneur who both feels most keenly the burden of starting a business with after-tax dollars, and will have the least access to the capital or debt markets for financing pre-opening costs. In a year when the White House has sponsored a Conference on Small Business, with the avowed aim of aiding small business to compete as an economic force in this country, the problem described above appear even more acute, and our tax policy even more questionable.

It should be noted that, while our preceding comments are set in the context of a new business which ultimately does begin operation as a going concern, much the same difficulty arises where it is determined that there is no place in the market for the new venture, and the investigation is dropped before the business ever starts. If the investigation of the new venture's feasibility has been carried on by a corporation, the start-up costs can probably be deducted by the corporation as a loss, should the decision be made not to operate the business. However, an individual incurring the same costs and reaching the same decision will, in all likelihood, never get a deduction for those costs even after abandoning the venture: losses for individuals would only be permitted were the transaction one "entered into for profit," and there is judicial precedent that such investigatory expenses do not qualify.

THE PROPOSED SOLUTION—H.R. 5729

We are pleased at the introduction of H.R. 5729 by Congressman Conable (and by the introduction of the same bill, as S. 1638, on the Senate side by Senator Roth). These bills make major strides in redressing the balance in favor of the small business entrepreneur, from a tax point of view, by permitting amortization of pre-opening expenses over a 60-month period starting with the time the venture becomes a going concern.

Since start-up costs can only be amortized by the going concern business, the bill obviously does not address the deductibility of investigatory expenses for the new business which never gets started. Failure to address this problem maintains the inequity and tax penalty where an individual investigates a new busi-

ness and ultimately determines there is no place for it; however, present tax laws allow at least limited relief for such circumstances if the individual is willing to incorporate the venture before proceeding with the investigation, so that ordinary loss treatment will be permitted on the disposition or liquidation of the corporation to the extent allowed by Internal Revenue Code section 1244. Accordingly, we do not believe the emphasis in H.R. 5729 on the going concern business is inappropriate or misplaced.

We would offer two suggestions to clarify the bill, and ascertain that it will carry out its intended effect. Under both House and Senate bills, start-up expenditures which are amortizable must be chargeable to capital account; of the type which would be amortizable over the life of the business if it had a determinable life; and an ordinary and necessary "expense." What is not clear is the availability of the start-up expenditure amortization for what would be, for example, Under the Supreme Court decision in *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), in which depreciation on transportation equipment was required to be capitalized (rather than currently deducted) where such equipment was used by taxpayer in the construction of its own assets, it is quite possible that analogous reasoning could require depreciation expense incurred before a new venture reached going concern status to remain capitalized, on the grounds that the reference in H.R. 5729 to "an ordinary and necessary expense" covered by items deductible under Code section 162, rather than other sections such as 167 (dealing with depreciation).

Accordingly, we would recommend removing any ambiguity by rewording new section 193(b) to eliminate the word "expense," as follows:

"(b) **Startup Expenditures Defined**—The term "startup expenditures" means any expenditure which is—

- (1) ordinary and necessary;
- (2) incident to the investigation, formula, formation, or creation of the trade or business;
- (3) chargeable to capital account; and
- (4) of a character which, if expended incident to the investigation, formation, or creation of a trade or business having a determinable life, would be amortizable over such a life."

Our final point concerns today's rules on pre-opening expenses. There is still substantial dispute, under present law, as to when an expenditure is considered pre-opening and when it is an ordinary and necessary expense of carrying on a trade or business. Some of that dispute will remain, even if H.R. 5729 is enacted, since start-up expenditures may not be amortized until the new business becomes a going concern—and that will obviously be a factual, subjective determination. However, cases presently on the books indicate no unanimity as to when a taxpayer crosses the line from pre-operating to going concern posture. For example, in *Richmond Television Corporation v. United States*, 345 F. 2d 901, 65-1 USTC ¶ 9395 (4th Cir., 1965), the costs of training personnel to operate a television station were not deductible—but were instead considered pre-operating costs—until an FCC license was obtained for the station, rather than after the construction permit for the TV station was issued. However, in *First National Bank of South Carolina v. United States*, 558 F. 2d 721, 77-2 USTC ¶ 9526 (4th Cir., 1977), the Fourth Circuit permitted an existing bank to deduct a \$63,000 assessment as a start-up cost, where taxpayer joined the Atlantic States Bankcard Association for purposes of offering its customers access to the Master Charge credit card, though it had never had a bank card service before. In this case, since the bank had been in existence for some time, the otherwise capitalizable costs of preparing to offer a new service became deductible as ordinary and necessary expenses. Other cases, both permitting and denying similar deductions, could be cited.

It is not our purpose to argue that the two cases cited above are inconsistent, or that one is right and one is wrong; rather, we would point out that taxpayers incurring this type of cost prior to the effective date of H.R. 5729 should not be precluded from arguing for deductibility of their expenses on the grounds that since H.R. 5729 permits amortization of certain types of expenditures in the future they clearly were not deductible or amortizable in the past. Accordingly, we would urge the committee reports with respect to this bill and S. 1638 to include language that enactment of new Code section 193 is not intended to create any presumptions about the state of the law concerning start-up expenditures in prior taxable years.

CONCLUSION

The inequity of tax treatment between start-up costs and going concern costs is real. It is a fact that many new businesses fail each year, and some fail due to the difficulties in overcoming the initial costs of starting the business.

Present tax rules add to this burden and, consequently, enhance the opportunity for business failure. H.R. 5729 and S. 1638 would do much to alleviate the problem by effectively cutting the costs to investigate and start up a new business—and only for those same costs which would reduce taxes after the business became a going concern.

Finally, we hope Congress can see the wisdom of this bill without the need for substantial concerted lobbying. Since the bill benefits primarily businesses not yet in existence, it is easy to see why it will not necessarily have a strong, vocal constituency. Still, it warrants passage—particularly with the clarifications we are suggesting—and we hope it will receive your urgent, and favorable, consideration.

Mr. ROSTENKOWSKI. Mr. Clevenger.

**STATEMENT OF PAUL W. CLEVINGER, VICE PRESIDENT,
TAXES, UAL, INC.**

Mr. CLEVINGER. Thank you, Mr. Chairman.

I am Paul Clevenger. I am vice president for taxes for UAL, Inc., and our address is Post Office Box 66919, Chicago, Ill.

UAL, Inc., is a parent holding company for United Airlines, Western International Hotels, and GAB Business Services, an insurance adjusting firm.

My testimony this afternoon is in support of the House bill 5729, a bill generally described as providing for the amortization of startup costs paid or incurred in starting a new trade or business.

H.R. 5729 and its companion, Senate bill S. 1638, have a declared purpose of helping new businesses to survive infancy by allowing the amortization of certain startup or preopening expenditures over a period of time not less than 60 months as selected by the taxpayer.

The definition of such startup expenditures as contained within the bill includes all ordinary and necessary expenses incident to the investigation, formation and creation of a trade or business which are chargeable to a capital account and which would be amortizable if the trade or business to which they relate had a determinable life.

It is not the purpose of my testimony to point out the vagaries that exist within the definition of "startup expenditures" as contained in H.R. 5729. For example, the problem of what constitutes an ordinary and necessary investigative expense is at best a very difficult problem but yet one, I believe, which can be resolved with appropriate regulations.

The thrust of my testimony this afternoon has to do with an implied assumption in H.R. 5729 and a litigative position taken by the Internal Revenue Service in direct opposition to such assumption. The assumption in H.R. 5729 to which I am referring is contained in the paragraph entitled "Election to Amortize." The first sentence of that paragraph states in part, "Startup expenditures paid or incurred by a taxpayer prior to the trade or business functioning as a going concern may * * * be treated as deferred expenses." That expression assumes that a taxpayer can be engaged in a trade or business prior to the time that the taxpayer's activities have reached the status of a "going concern."

Following a line of cases starting with Petersburg Television Corp., TCM 1961-49, and Richmond Television Corp., 345 F. 2d 901 (1965), the Internal Revenue Service has taken a contrary position, that is, that for purposes of determining an ordinary and necessary business expense, a trade or business status is not deemed to exist until such enterprise had reached the "going concern" state.

The full impact of the Service's position comes into play when you consider an expenditure such as the cost to advertise a "grand opening." Such an expenditure while clearly ordinary and necessary to a beginning business would not fit within the definition of "startup expenditures" as contained in H.R. 5729 since it isn't ordinarily considered to be chargeable to a capital account.

On the other hand, under the Internal Revenue Service approach, the expenditures, while conceded to be ordinary and necessary, would not be deductible by the taxpayer since the taxpayer was not engaged in a trade or business at the time the expense was incurred as required by section 162 of the Internal Revenue Code. The expenditure in the eyes of the Internal Revenue Service would therefore neither be capitalizable nor deductible—although conceded to be clearly ordinary and necessary.

While the old *Richmond* and *Petersburgh* cases involved expenditures made well in advance of the receipt of authority to construct television stations and thus could be argued not to fully support the Internal Revenue Service's current litigative position, the more recent case of *Playboy Clubs International, Inc.*, 76-2 USTC ¶ 9560 (followed by an unpublished opinion upon appeal to the 7th circuit issued on May 16, 1977), clearly demonstrates the Service's current position.

In that case, the taxpayer organized several new subsidiary corporations for the purpose of operating a new private key club facility in each such corporation. Prior to the opening date of the various key clubs, the taxpayer/corporations incurred expenses under the broad categories of "travel and entertainment," "compensation of officers," "salaries and wages," "advertising," "repairs" and "rent". The service's position was that since those expenses had been incurred prior to the opening date of the respective clubs, the taxpayers were not engaged in a trade or business and were therefore not entitled to deduct such expenses.

While the taxpayer's position was generally sustained on appeal, it was done only by the appellate court finding that the selling of club-keys well in advance of the opening date constituted the carrying on of a trade or business thus qualifying the expenses in question as ordinary business deductions. It is fairly clear that absent the special selling activities which produced current revenues, the court would have had a difficult time arriving at the same decision.

I should note here that while a large corporation was involved in the *Playboy* case, in Revenue Ruling 73-421 the service took the same position in relationship to a boys camp as they did in the *Playboy* case.

There is also a private ruling letter issued very recently 7842007, involving a nursing home. Both the private ruling letter and Revenue Ruling 73-421 were to the effect that until the doors have opened the taxpayer is not conducting a trade or business.

In summary, H.R. 5729 is a good bill and deserves to be enacted but it only addresses a portion of the problems a new business faces, that is, the amortization of capital-type expenses incurred in the formation of a new business. It should, however, be expanded to deal with those ordinary and necessary noncapital expenses which every new business incurs prior to obtaining a going concern status. These latter expenses, which are the type the Internal Revenue Service seeks to disallow, are generally the more numerous expenses and their deductibility would go a long way in helping new businesses survive their infancy.

I believe the seed to the solution rests in the regulations under section 248 of the Internal Revenue Code. These regulations which deal with the amortization of organizational expenses incurred by a taxpayer/corporation, provide that for the purpose of determining the 60-month amortization period, the taxpayer/corporation's trade or business is deemed to commence when the nature of the business has been clearly established by an overt act such as the acquisition of operating assets which are necessary to the type of business contemplated.

If such a presumption were to apply to the definition of the commencement of a trade or business within the meaning of section 162 of the Internal Revenue Code, beginning businesses would be reasonably assured that they could obtain a tax benefit for all ordinary and necessary expenditures incurred prior to obtaining the status of a "going concern" either as direct business deductions or as amortizable capital expenditures as currently provided by H.R. 5729.

This concludes my prepared remarks, Mr. Chairman.

Mr. ROSTENKOWSKI. Thank you.

Gentlemen, you have expressed some apprehension as to how fast we should move with this legislation. I think you would help this committee immeasurably if you could give us in writing some ideas about technical issues you foresee in legislating in this area. I think that would be most helpful to us if you could be in touch with the staff of the Select Revenue Measures Subcommittee and discuss with them specifically what you feel would be the fairest approach to the improvement of this legislation.

I want to thank you very much for joining us this afternoon.

[The following was subsequently received:]

TOUCHE ROSS & Co.,
Washington, D.C., April 25, 1980.

HON. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR CONGRESSMAN ROSTENKOWSKI: At the time I testified, on behalf of Touche Ross & Co., before your subcommittee on April 17 with respect to H.R. 5729, you requested that the members of my panel supply you with our thoughts on the question of when a business should be considered to have become a "going concern." The question was generated from the proposed statutory language in H.R. 5729, and companion bill S. 1638, to the effect that startup expenditures would be amortizable beginning with the month the trade or business "starts functioning as a going concern." Because of the highly subjective nature of this phrase, you requested any additional thoughts we might have as to how (or if) that language could be clarified.

Fortunately, there is guidance in the Code and regulations which could be helpful, though it may be desirable to change slightly the statutory language of H.R. 5729 to reflect a parallelism with other Code sections in order for the regulatory language I shall suggest to be applicable.

The 83rd Congress, in enacting the original 1954 Code, added a new section 248 to permit, for the first time, the amortization of certain very limited expenditures incurred in organizing a corporation. Under section 248, a 60-month minimum amortization period is required, and the period starts "with the month in which the corporation begins business." Regulations under this section, while recognizing that the determination of that month presents a question of fact, provide some guidance as to when the amortization period begins.

"The words 'begins business,' however, do not have the same meaning as 'in existence.' Ordinarily, a corporation begins business when it starts the business operations for which it was organized . . . Mere organization activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operation, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business."

The regulatory provision, in existence since 1956, seems to have provided a workable guideline for most organizing corporations.

Much more recently, in 1976, a similar statutory rule (Code section 709) has been adopted with respect to the organizational expenses of a partnership, and the statutory language with respect to the point at which such expenditures become eligible for amortization is identical to that of section 248: amortization commences with the month in which the partnership "begins business." On January 11 of this year, proposed regulations under section 709 were issued, and again the regulatory language—at least in proposed form—is completely parallel to that in the final regulations cited above for section 248.

There is one additional place in the Code and regulations where it is possible to find guidance on this subject. Under the Subchapter S rules, a corporation is not disqualified from Subchapter S status by deriving excessive amounts of passive income, provided that the year in which the passive income test is failed is "the first taxable year in which the corporation commenced the active conduct of any trade or business . . ." (section 1372(e)(5)(B)(i); emphasis supplied). While this is not identical with the "begins business" wording of sections 248 and 709, the language is obviously closely related, and Treasury has interpreted this language similarly in the section 1372 regulations:

" . . . corporation will be deemed to have commenced the active conduct of a trade or business in the taxable year in which it first engages in activities (other than activities merely incidental to the organization of the corporation) designed or intended to enable it to engage in any business operations. Thus, for example, a corporation organized to operate a restaurant business will be deemed to have commenced the active conduct of a trade or business . . . in the taxable year in which construction of the restaurant facility is undertaken or real property is purchased or leased by the corporation for such use." Reg. Sec. 1.1372-4(b)(5)(ii).

While we support the concept of H.R. 5729, and feel the bill deserves passage, we can see the merit in not introducing still another subjective concept (the "going concern" test) in a statute which is clearly analogous to the one granting tax relief for expenses of organizing a corporation or partnership. Accordingly, we would suggest changing the proposed language of new section 193 so that the "going concern" test is replaced by a "begins business" test. While we would anticipate the regulations under the "going concern" test would be functional in nature—as are those under sections 248, 709, and 1372—we feel very little will be gained by such subtle differentiations in language as might occur should H.R. 5729 be adopted with the "going concern" criterion.

I would also like to take this opportunity to include an additional comment for your consideration. Based upon the testimony of the other witnesses in my panel, I am concerned as to the possible nonapplication of section 193 to an existing business investigating a new product or service line, or preparing to open a new branch. For example, it is at least arguable that—by way of illustration—an existing retail department store investigating and starting up a new branch in a different city could be held not eligible for the benefits of sec-

tion 193 on the grounds that the organization is already a "going concern" or has already begun business, in its service or product line—though not in the new location. Based on that argument, it could be held that since the retailer was not entitled to the benefits of section 193 (which applies only to costs incurred prior to becoming a "going concern"), it would come, therefore, under the old rules whereby no deduction would ever be allowed for the new branch investigation or start-up until termination of the corporation.

This, we would suggest, is manifestly unfair and inequitable. We would certainly not seek special advantage for the enterprise already in operation and wishing to expand to a new service or product line or new location. However, we also do not believe that such an enterprise should be penalized by an unduly narrow reading of this new Code section. For example, what kind of policy would it be that would preclude the existing retailer from obtaining tax benefits to investigate and start up a branch in a new city, but would permit one of that company's employees to resign, take with him all the training and knowledge he has obtained working for that company, and himself investigate and start a competitive store in the new city—and be entitled to amortize his investigation and start-up expenditures?

We trust that the statute or the committee reports will make it clear that it is not intended to penalize existing businesses if they would otherwise meet the qualifications to amortize expenditures under section 193, and that the new section should be given reasonable interpretation as applicable to existing organizations.

Please let me know if we may be of further assistance to you or the committee staff as you continue your consideration of this important and deserving bill.

Sincerely,

GERALD W. PADWE,
Associate National Director—Tax Services.

Mr. ROSTENKOWSKI. We will hear from Mr. Diamond and Mr. Jones next.

We welcome you to the subcommittee, gentlemen. We appreciate your joining us this afternoon. Would you please identify yourselves and proceed.

STATEMENT OF LOUIS H. DIAMOND, ESQ., WASHINGTON, D.C.

Mr. DIAMOND. I am Louis H. Diamond and I practice tax law at 1120 Connecticut Ave., NW., in Washington, D.C.

Many of my clients are small entities that sponsor qualified deferred compensation plans and they are quite concerned with the scope and the thrust of H.R. 6140. We certainly have a problem here that needs to be rectified.

As I would see the problem, what we are dealing with is that we are artificially dividing a single business enterprise into more than one entity for the purpose of limiting coverage under qualified deferred compensation plans or, more in your vernacular, a gerrymandering of one business enterprise to accomplish a purpose that certainly should not be allowed.

This is not a new problem. It has been around for a long time. It was focused on by Congress in 1974 when ERISA became law and ERISA inserted sections 414 (b) and (c) into the Internal Revenue Code to deal with this problem.

I believe, however, that the ERISA answer, 414 (b) and (c), is imperfect. It is inadequate. It is too broad in scope and too narrow in its application. In terms of too broad in scope it encompasses within its rules unrelated businesses that have no reason or no logic to being lumped together.

For instance, one of my clients is a construction company that has adopted a pension plan. The principal owner of that company was a soccer enthusiast who bought the local soccer team. Well, all of a sudden the employees of the soccer team being mostly semiprofessional earn considerably less than the employees of this construction company and unless he puts a pension plan in for the soccer team, he has jeopardized the continued tax exemption for the pension plan of his construction company.

I think it is clear in 414 (b) and (c) and I think it is beyond the scope of what was intended in 414 (b) and (c). While we have a provision that is too broad in scope unfortunately it seems to not work, nevertheless, it is too narrow in its application and thus the *Garland* case. It is easy to circumvent these provisions.

What is needed is a better answer to this problem. What should be done is insofar as it applies here, we should revamp 414 (b) and (c) and we should change the tenor of these sections and broaden their scope so that all adjunct entities are included. In an adjunct entities I am satisfied with the approach used in 6416, therein determining the interrelationship between entities and defining them as adjunct entities.

I prefer the use of "entities" rather than "organization," and otherwise I would go along with that. However, I would narrow the application.

I submit that a subjective approach is used instead of the objective one now. It is nice to be able to just work some numbers and say you are in or you are out, but the net result is you get a very imperfect result and that is what we have, a very imperfect result and one that doesn't work.

I suggest in effect using a scalpel rather than a shotgun. The scalpel that I would suggest is that once you have an adjunct entity and where you would apply the section in instances where the taxpayer cannot show that a separate entity was not formed or availed of principally for the reason of excluding employees from coverage under a qualified deferred compensation plan maintained by an adjunct entity.

In other words, there is a section in the Internal Revenue Code that has worked quite well for years, section 269, and it looks to intent. In my opinion the use of that approach applied in the *Garland* situation, neither of the taxpayers could have survived that kind of 269 type burden and have accomplished what that Tax Court ultimately allowed them to do.

Lastly, I would extend the scope to all entities. I would not do as 6140 does to limit it to professionals. There is unanimity there that the problem is not a localized one and the answer should be broad in scope. Thank you.

[The prepared statement follows:]

STATEMENT OF LOUIS H. DIAMOND, Esq., WASHINGTON, D.C.

I am a lawyer specializing in tax practice with the law firm of Danzansky, Dickey, Tydings, Quint & Gordon. I represent numerous small corporations which sponsor qualified deferred compensation plans. These corporations frequently encounter problems in complying with Section 414 (b) and (c) under circumstances which are beyond that which I believe to be the intended scope of this section.

Nevertheless, there are also abuses that are not prevented by the application of this section. Accordingly, legislation is needed to rectify this presently unacceptable situation, but I do not believe that H.R. 6140 is the right answer.

Owners of a single, unified, business enterprise have, upon occasion, sought to "gerrymander" that enterprise into separate legal entities for the purpose of adopting qualified deferred compensation plans in some, but not all, of the segments of that enterprise, thereby excluding from coverage the employees of those segments which do not adopt such a plan.

Congress sought to remedy this situation in the Employee Retirement Income Security Act of 1974 (ERISA) by adding Section 414 (b) and (c) to the Internal Revenue Code. This section utilized the concepts and provisions of Sections 1561-1563 (dealing with multiple corporations) to tie together commonly owned entities for purposes of testing the adequacy of coverage under a qualified plan adopted by any one of them.

The Section 414 (b) and (c) answer to the employee plan coverage problem has proven to be inadequate in that it has both produced anomalous and unintended results, and has not prevented the abuse for which it was intended (see, e.g., *Garland v. Commissioner*, 73 T.C. — No. 2 (1979)). More specifically, it has proven to be both too broad in its scope and too limited in its effectiveness. It is too broad in that it ties together unrelated businesses that are totally dissimilar but nevertheless cannot stand alone and pass the "reasonable cross-section test" of Section 410(b)(1)(B). For instance, in one situation the exempt status of the qualified plan of a construction company was jeopardized when its owner acquired the majority interest in a soccer team, the employees of which earned less than all but a few of the employees of the construction company. We believe that this is not consistent with congressional intent.

Despite the overly broad scope of Section 414 (b) and (c), it has, nevertheless, proved to be inadequate in accomplishing its intended purpose of preventing gerrymandering, as *Garland* so graphically portrays. We believe that this problem is in dire need of rectification. Its resolution should not, however, be approached on a selective basis, singling out but one segment of our business community (i.e., professionals), while leaving all others with the freedom to continue gerrymandering under court approval and with the guidance provided by *Garland*.

I believe that Section 414 (b) and (c) should be revamped. The revamped Section 414(b) should utilize the approach contained in H.R. 6140, with the following changes:

1. It should apply to all entities which are functionally related in the rendering of a single service or the production of a single product.

2. It should apply only in circumstances where related entities are formed or availed or principally for the purpose of excluding employees from coverage under one or more qualified deferred compensation plans.

It is my opinion that the problem here involved is inherently subjective by nature, and does not readily lend itself to an objective answer, such as that now contained in Section 414 (b) and (c). My purpose is to prevent an abuse. Accordingly, the answer should correlate as closely as possible with the nature of the problem. By analogy, I believe that, in this instance, a well applied "scalpel" will produce a far better result than the existing "shotgun."

I recognize that there is a certain amount of comfort inherent in a statutory provision that can be mechanically applied. But where, as here, the problem to be rectified is largely characterized by improperly motivated use of what would otherwise constitute separately cognizable entities, I believe that a subjective answer to the problem will be far more effective. Moreover, there is ample precedence and existing court authority for the application of such a subjective test to analogous fact situations. Section 269 has long been an effective provision of the Code. It has received extensive court interpretation and has been quite successful in preventing abuses analogous to the one perpetrated by the taxpayer in the case of *Garland v. Commissioner*, 73 T.C. — No. 2 (1979). I submit that it would be most unlikely that the taxpayer in *Garland* would be able to convince a court that the partnership which was formed to employ non-prohibited group employees was not "formed or availed of" for the proscribed purpose. Accordingly, under the revision which I propose, the employees of that partnership would be considered to be part of the employee population of the related entity which employed only the prohibited group owner-employees.

Section 1551 is another example of the use of a subjective test to deny tax benefits to an entity formed for the principal purpose of obtaining such tax benefits. This section also contains an added presumption which would disallow the sought after tax benefits.

"* * * unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such benefits or credit was not a major purpose of such transfer."

While I do not believe that such an added presumption would be necessary to accomplish the purpose here desired, I would not oppose the addition of such a presumption.

In summary, it appears to me that the *Garland* case presents a major problem that is in need of immediate rectification. The existing statutory answer to this problem is clearly deficient. What is needed is a subjective answer that can be applied where needed on a selective basis, rather than the overly broad, but otherwise insufficient answer now contained in Section 414(b) and (c) of the Code. The problem is not limited to any particular segment of our economy—such as professionals. It runs the gamut of business activity. Therefore, the answer should not be one that singles out any particular segment of our taxpayer population. Instead, it should apply across the board in all abuse situations, regardless of the nature of the business involved. I believe that my suggested approach would provide the proper format. I would look forward to the opportunity to assist this Committee in the formulation of legislation that will accomplish this desired result.

Mr. FOWLER [presiding]. Thank you for the specificity of your presentation.

Mr. Jones.

STATEMENT OF BRIAN A. JONES, CONSULTANT, B. A. JONES & CO., INC., NEW YORK, N.Y.

Mr. JONES. I am Brian Jones, a consulting actuary, and my address is 17 Battery Place, New York, N.Y. 10004.

I give in my prepared testimony a number of examples of ERISA problems which I don't need to repeat here and continue.

I believe that there is a single reason for the above problems and the many other ERISA problems which are simply too numerous to list. This is the attempt to sit down ahead of time, foresee all of the future problems in a highly technical area and to solve them in advance by writing into a statute a vast number of very complex mechanical rules. The results of this kind of approach will be to prohibit some practices which were intended to be prohibited, prohibit a vast number of others which are not objectionable, and to miss a large number which are. The provisions of section 414(b) and (c), and here I agree with Mr. Diamond, is just one example of this.

They were intended to tighten up the rules on the use of multiple corporations or other organizations, and in fact they end up permitting the *Garland* situation.

If the IRS had the same discretion to look through form to substance which they had pre-ERISA this would never have been attempted. However, the Tax Court points out in its opinion that the control group rules were lifted into ERISA or lifted by ERISA into the qualified plan area as the exclusive remedy for some abuses which had arisen from the use of multiple organizations.

This had two results: First it opened up the kind of abuse which appeared in *Garland*; and, perhaps even more serious, it disrupted pension plans of some totally unrelated but commonly owned business

organizations. Let us assume that a medical partnership has a plan covering its employees and the principals. Let's also assume that the principals decide later to invest in a local pizza parlor. If they invest equally and own more than half of that pizza parlor and if it has a number of low-paid employees the result will be that the partnership plan will be disqualified, eliminating benefits for employees as well as principals. There will be no room to argue that the pizza parlor and the medical practice are totally unconnected; that the doctors had no idea that this would be the result of their investment; or that the bulk of the people who are hurt are not principals. Clearly this is indefensible. The rules of section 1563 on surtax exemptions, et cetera, are reasonable and generally accepted. When they are taken over into the qualified plan area they produce this kind of absurd result.

Now, along comes H.R. 6140 and repeats the same basic errors. It is far too complex; it misses its target; and it hits other unintended targets.

The complexity of the bill is obvious on even a fast reading and it is magnified by the incorporation of section 267 attribution rules. The pension practitioner must now be conversant with not just section 1563 but also the very different rules of section 267.

The target which is missed is the Garland situation itself. I am sure there are half a dozen different ways around 6140—certainly half a dozen different people have told me that they have a way worked out already. The one which occurred to me immediately was to set up a service corporation owned by the employees, not the doctors, and have the partnership contract with it for administrative services. The doctors would have no need to control such a service corporation or to own stock in it since they control its income; they could even be the directors and/or officers and still avoid the mechanical rules of the bill.

Finally, the bill will hit at least one unintended target and create an absurd problem for people who were never intended to be reached. This is described in detail in my prepared statement.

I believe that rather than using the approach of H.R. 6140, subsections 414 (b), (c) should be rewritten to provide that in situations where a single profession or business is conducted through multiple entities, the employees must be treated as employed by a single employer and that where a single profession or business contracts out services typically provided by employees, to an organization which has as its main function the provisions of such services to that profession or business, the employees of the two must also be aggregated. I do not believe that it is possible to tie down all of the dividing lines in advance without repeating the errors described above but it is certainly possible to provide in the statute or in the accompanying reports guidelines for future regulations and rulings, and I give examples in the prepared testimony.

I believe that not only is the above approach the right way to handle the Garland problem, it could also be the start of a drastic pruning of ERISA which would improve it immensely. I seriously believe that the ERISA statute is too big by a factor of more than 10. Many of the complex rules which appear in the statute belong either in regulations or revenue rulings. Most do not belong at all. I realize that when I advocate that ERISA should be drastically pruned I will be

dismissed as a crank but I am confident that almost all professionals in the qualified plan area would agree. Many of them, perhaps a majority, could write a statute one-tenth the size of ERISA which would retain any good results and avoid most of the problems.

[The prepared statement follows:]

STATEMENT OF BRIAN A. JONES, NEW YORK, N.Y.

I am Brian Jones, a consulting actuary. I have been practicing exclusively in the qualified pension area for the last fifteen years. For the first ten of these, I considered myself a professional; for the last five, since the passage ERISA, I have been nothing more than an adjunct to a huge bureaucracy administering the most misguided piece of legislation I have ever seen or ever expect to see.

I do not criticize these bureaucrats as individuals; by and large they are attempting to do a competent job. In many cases they are overwhelmed but, despite this, are very helpful in responding to questions or problems.

I am also sure that the people who developed ERISA were guided by the best of motives. Nevertheless, I believe that the act has been a major disaster. Its only good effect, from my point of view, has been to substantially increase my income partly from the termination of adequately funded, healthy plans which were terminated purely because of ERISA. At first, I tried to stem this tide of terminations and assured the plan sponsors that ERISA was really not so bad after all. On reflection, I think that in many cases my attempts were misguided and the people who terminated these plans were wise.

It is possible to criticize bits and pieces of ERISA endlessly. Virtually every section which I have had occasion to analyze thoroughly contains errors, inconsistencies and worst of all, incredible complexities and I am continually finding new ones. A few of these, selected purely at random and by no means constituting a comprehensive list, are as follows:

1. The intricate rules of Section 415, which were intended to limit the use of qualified plans as a tax shelter for the wealthy, have made it possible to shelter very high percentages of income in a way which never would have been possible under the pre-ERISA rules.

2. The Break-in-Service concept—which really belongs only in multi-employer plans where employees move from one employer to the other and “termination of employment” has no significance—has been forced into single employer plans producing ridiculous results.

3. The new participation rules and the pre-retirement survivor annuity requirements have created major problems for individual policy insured defined benefit plans. Ironically, the defined benefit plan is the one plan under which it makes very little difference when participation begins and the individual policy insured plan provides death benefits, usually to the spouse, far in excess of those provided by the pre-retirement survivor annuity provisions. The IRS, rather than helping to ameliorate these problems, has produced regulations which make them much worse.

4. Through what I assume to be a drafting error, the funding standards of ERISA are suspended under the Individual Level Funding actuarial cost method in a situation where it is possible (and I have seen this occur in practice) that the plan does not have sufficient assets on hand to pay the accrued benefits. If the employer makes a contribution in this situation, a deduction is denied. In correspondence with me and it appears likely by future regulation, IRS rather than attempting to rectify or limit this anomaly is extending it to situations which the statutory error does not reach.

With one important exception, I have yet to see a benefit flow to a pension plan participant as a result of ERISA: the exception is the liberalized vesting which has resulted from ERISA and which could have been achieved by means of an amendment to the Internal Revenue Code of less than one hundred words.

I expected to see some benefit from the fiduciary responsibility sections but within the past few weeks I and an aggrieved participant in a small plan, were brusquely told by the Department of Labor that his problems were too far down in their list of priorities for us to expect any help; they were, we were told, “only going after union plans especially teamster plans!” I was not impressed, perhaps because much of my practice is with multi-employer plans, including some teamster plans.

Some participants may have benefited from the new PBGC provisions but I really cannot consider PBGC as an overall benefit. When it was set up it was intended to provide three things: termination protection to single employer plans; the same protection to multi-employer plans; and, "second tier" protection to employers against the employer liability resulting from the indemnity provisions in the first two. The score card is as follows: the single employer premium has gone up from \$1 to \$2.60 per head; PBGC itself has decided that multi-employer plan protection as originally written is unworkable; and, no second tier protection has been provided but the employer liability remains. I shudder to think what would have happened had I designed a three phase program for a client under which the first phase turned out to be almost three times as expensive as I had estimated and the second and third phases proved to be completely unworkable.

I believe that there is a single reason for the above problems and the many other ERISA problems which are simply too numerous to list. This is the misguided belief that it is possible to sit down ahead of time, foresee all of the future problems in a highly technical area and to solve them in advance by writing into a statute a vast number of very complex mechanical rules. The results of this kind of approach will be to prohibit some practices which were intended to be prohibited, prohibit a vast number of others which are not objectionable, and to miss a large number which are. The only people who can benefit from this kind of thing are not the people who were intended to benefit, rather, they are people like me who are paid to chart a course through the rocks. Charting a course through naturally occurring rocks is an honorable profession; spending one's life charting a course through rocks which were thrown deliberately but in the wrong direction is merely frustrating.

The provisions of Code Section 414 (b) and (c), as introduced by ERISA, are just one example of this basic error. They are intended to tighten up the rules on the use of multiple corporations or other organizations. In fact, they end up permitting the Garland situation where one of two doctors practicing in a partnership incorporated himself, had the corporation step into his shoes as a partner, and then set up a plan in the corporation for himself alone.

Had the IRS been left with the kind of discretion to look through form to substance which it had pre-ERISA, this would never have been attempted. However, as the Tax Court pointed out in its opinion, the "controlled group" rules were lifted by ERISA into the qualified plan area as the exclusive remedy for some abuses which had arisen from the use of multiple organizations. This had two results: first, it opened up the kind of abuse which appeared in Garland; and, perhaps even more serious, it disrupted pension plans of some totally unrelated but commonly owned business organizations. Let us assume that a medical partnership has a plan covering its employees and the principals. Let us also assume that the principals decide later to invest in a local pizza parlor. If they invest equally and own more than half of that pizza parlor and if it has a number of low-paid employees, the result will be that the partnership plan will be disqualified—eliminating benefits for employees as well as principals. There will be no room to argue that the pizza parlor and the medical practice are totally unconnected; that the doctors had no idea that this would be the result of their investment; or that the bulk of the people who are hurt are not principals. Clearly this is indefensible. The results of Section 1563 in the area of multiple surtax exemptions etc., are reasonable and generally accepted. When they are taken over into the qualified plan area they produce this kind of absurd result.

Now, along comes HR 6140 and repeats the same basic errors. It is far too complex; it misses its target; and it hits other unintended targets.

The complexity of the bill is obvious on even a fast reading and it is magnified by the incorporation of Section 267 attribution rules. The pension practitioner must now be conversant with not just Section 1563 but also the very different rules of Section 267.

The target which is missed is the Garland situation itself. I am sure there are half a dozen different ways around 6140—certainly half a dozen different people have told me that they have a way worked out already. The one which occurred to me immediately was to set up a service corporation owned by the employees, not the doctors, and have the partnership contract with it for administrative services. The doctors would have no need to control such a service corporation or to own stock in it since they control its income; they could even be the directors and/or officers and still avoid the mechanical rules of the bill.

Finally, the bill will hit at least one unintended target and create an absurd problem for people who were never intended to be reached. This is most easily explained by visualizing a hypothetical situation of a general practice law firm which uses a special tax counsel on a regular basis. Assume that this special tax counsel is an individual practitioner with one or two fairly highly paid paralegal assistants who also handle his secretarial work. It seems to me that the sole-practitioner performs professional services for the general law firm. His one lawyer firm meets the definition of an adjunct professional organization because his employees perform services for him and he is a person who performs professional services. The general law firm clearly meets the definition of a professional organization. The professional organization regularly uses the services of the adjunct professional organization, the one lawyer firm. One of the individuals performing professional services for the professional organization is our sole-practitioner and he owns 100 percent of his own firm. All of the requirements for relationship of the two organizations are, therefore, met.

I think that the above result is independent of the form of organization of the general law firm and is also independent of whether the sole-practitioner practices as an individual or as a professional corporation. Even if he is practicing in a professional corporation which employs him and the two para-legals, he nevertheless performs professional services as an individual for the general firm—for example, if he appears in tax court litigation for a client of the general firm, he will be the attorney of record as the tax court requires that the attorney of record be an individual and not a firm.

If the general firm does not have a pension plan and the one lawyer firm does, and if, as would be the case in this hypothetical, he and his employees do not form a Section 410(b)(1)(B) "stand alone group" for pension purposes, the result is that his pension plan will be disqualified. I assume that this was not intended but I think it is virtually impossible to read the bill so as to avoid this result. I can, of course, think of arguments based on the intent of the legislation, etc., which might be used to try to avoid it but I feel no certainty that they would prevail and I believe that it would, therefore, be disastrous for the bill to be passed as it stands.

I believe that rather than using the approach of HR 6140, Subsections 414(b) and (c) should be re-written to provide that in situations where a single profession or business is conducted through multiple entities, the employees must be treated as employed by a single-employer and that where a single profession or business contracts out services typically provided by employees, to an organization which has as its main function the provision of such services to that profession or business, the employees of the two must also be aggregated. I do not believe that it is possible to tie down all of the dividing lines in advance without repeating the errors described above but it is certainly possible to provide in the statute or in the accompanying reports, guidelines for future regulations and rulings.¹ For example, it could be provided that where two entities are "controlled" under Section 1563, the burden of proof should be on the taxpayer to demonstrate that they are not a single profession or business and that the burden of proof would be reversed where the 1563 tests are not met. Where a single group of employees works essentially for two employers but the payroll is entirely in one, the two should clearly be aggregated. On the other hand, where two entities are in totally unrelated businesses such as the medical practice and the pizza parlor discussed above, where they are geographically separate, or where they serve different clients or customers, there should be no aggregation for qualified plan purposes even if there is a Section 1563 controlled group.

I believe that not only is the above approach the right way to handle the Garland problem, it could also be the start of a drastic pruning of ERISA which would improve it immensely. I seriously believe that the ERISA statute is too big by a factor of more than ten. Many of the complex rules which appear in the statute belong either in regulations or revenue rulings. Most do not belong at all. I realize that when I advocate that ERISA should be drastically pruned I will be dismissed as a crank but I am confident that almost all professionals in the qualified plan area would agree. Many of them, perhaps a majority, could write a statute one-tenth the size of ERISA which would retain any good results and avoid most of the problems.

¹ This recommendation is seriously weakened by the Proposed Regulations—1.411(d)-1 of April 9, 1980 which flagrantly ignore the congressional guidelines concerning vesting and discrimination.

Mr. FOWLER. Thank you, Mr. Jones, also for the whimsey contained in the total of your prepared statement.

Gentlemen, we appreciate very much your presentations.

Next is testimony on H.R. 6824, to preserve the application of existing law to nonqualified deferred compensation arrangements maintained by tax-exempt organizations.

Gentlemen, before you start, it will be necessary for me to vote, and we will take a short recess.

[Brief recess.]

Mr. FOWLER. We will resume. Will you begin, Mr. Vickerman.

STATEMENT OF JOHN C. VICKERMAN, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, WASHINGTON, D.C.

Mr. VICKERMAN. I am the Director of Public Affairs of the American Society of Association Executives, and we are located at 1575 I Street NW., in Washington. ASAE is a professional organization of 8,000 executives who manage America's leading trades, professional, educational, and charitable associations. I have provided a copy of my testimony and will very briefly summarize it.

ASAW supports H.R. 6824. Approximately 18 percent of our members have some sort of deferred compensation arrangement generally unfunded. This figure of 18 percent rises to approximately 33 percent in the case of major national trade associations.

These deferred compensation plans are the primary vehicle through which tax-exempt, nonprofit organizations can provide incentives to executive employees. Since in the association community there is no such thing as a stock option or a profit sharing plan.

These plans enable associations to compete with for-profit organizations for executive talent. Deferred compensation also gives associations leverage in retaining the services of these executives. In addition, the association has the right to use the deferred funds for its own purposes until the time of payment. This is particularly important to new associations or small associations.

H.R. 6824 would result in identical treatment for employees of exempt organizations and employees of for-profit organizations. We feel that this is equitable and correct, since both types of organizations are essentially private; they are not units of government and their employees are not public employees, and they compete for the same management and professional talent.

Public employee plans are unique, since governmental plans are exempt from ERISA, State and local governments, unlike exempt and for-profit organizations, are able to offer deferred compensation to all employees. And, given the taxing authority of these governments, their obligations are quite secure.

However, among tax-exempt organizations, ERISA restricts the use of deferred compensation plans to management level employees and professionals. This does not mean that there is no provision for rank and file employees. ASAE's salary and compensation studies indicate that the great majority of associations provide qualified retirement plans for their employees and the number doing so is increasing. We think it is obvious why this is so. An exempt organiza-

tion must compete for these employees, just as it must compete for executive talent.

There is no danger that deferred compensation plans will result in a decline in the number of qualified plans. Quite the opposite has been happening.

Finally, the number of persons working for tax-exempt organizations is tiny compared to the number working for taxable employers. It is clear that the total amount of deferred compensation in this area is not significant in terms of revenue impact.

Mr. Chairman, deferred compensation is used by associations in a wide variety of other exempt organizations, ranging from hospitals to labor unions. These organizations have limited resources, and to secure the services of the best people, they need to have the use of this tool.

We feel that H.R. 6824 is a reasonable bill which will confirm the existing status of deferred compensation plans, and we urge your favorable consideration. Thank you.

Mr. FOWLER. Thank you very much.

[The prepared statement follows:]

STATEMENT OF JOHN C. VICKERMAN, DIRECTOR OF PUBLIC AFFAIRS, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

SUMMARY

Nationally, there are thousands of highly skilled executives of nonprofit associations. These associations are generally voluntary, multipurpose organizations which promote the common business and professional interests of their member companies. Many of these association executives serve their associations under contracts which provide for unfunded deferred compensation.

Such unfunded arrangements constitute the primary vehicle through which a nonprofit organization can provide its executives with incentives to insure the continued viability of the association. Unlike profit-making corporations, the associations cannot offer their employees the traditional forms of incentive compensation based on profits, such as stock options, profit sharing plans, or stock purchase plans.

Unfunded deferred compensation plans are particularly well-suited to nonprofit associations, for several reasons. The most obvious advantage to the association is the right to use the employee's deferred payments for association purposes until the amounts are required to be paid to the employee. This factor is especially important to young associations seeking to establish their presence within a particular industry. Another advantage is the leverage which such plans give to associations in persuading valuable executives to continue in the service of the association until the expiration of the entire contract term. Provisions for forfeiture of deferred payments are also commonly used in association contracts to insure the availability of the executive as an advisor or consultant after the expiration of the term of active service. Finally, the nonprofit status of the association eliminates one of the major disadvantages which deferred compensation holds for profit-making corporations—the requirement of a corresponding deferral of the employers' deduction for compensation paid.

Therefore, The American Society of Association Executives supports H.R. 6824, which would preserve the application of existing law to nonqualified deferred compensation arrangements maintained by tax-exempt organizations.

STATEMENT

The American Society of Association Executives is a tax-exempt non-profit association comprised of association executives. Nationally, there are thousands of highly skilled executives who are employed by tax-exempt organizations. These organizations are principally voluntary, multi-purpose organizations which promote the common business and professional interests of their members. A key

component in the compensation package for many association executives is a contract provision calling for unfunded deferred compensation. Such unfunded deferred compensation arrangements constitute the primary vehicle through which a tax-exempt non-profit organization can provide incentives to its executive employees because traditional forms of incentive compensation based upon profits, e.g., stock options, profit sharing plans, or stock purchase plans, cannot be offered by tax-exempt organizations.

The tax treatment of such unfunded deferred compensation plans is critical to their effectiveness. An unfunded deferred compensation plan offers two principal advantages. First, it allows the employer to use the funds until the date for payment arrives. Second, it allows the employee to defer the income for tax purposes until the money is actually received, often many years later. The entire issue revolves upon when the money must be included in the taxpayer's gross income. If the taxpayer is obligated to pay taxes immediately, then the mechanism of deferred compensation would have little utility, especially in periods of spiraling inflation.

ASAE strongly supports H.R. 6824. H.R. 6824 provides simply that the tax treatment of unfunded deferred compensation paid to employees of tax-exempt organizations will continue to be treated pursuant to the long established rules and regulations of the Department of the Treasury. This treatment was accorded to unfunded deferred compensation paid by private businesses in the Revenue Act of 1978. That provision of the 1978 Act was enacted as a response to Proposed IRS Regulation § 1.61-16, which had been issued on February 3, 1978. This provision of the 1978 Act effectively blocked the final adoption of the proposed regulations, which would have scrambled the existing rules for tax treatment of deferred compensation. The provisions of the Act omitted tax-exempt organizations from its coverage.

The result is that the Internal Revenue Service is now considering adopting a modified version of its proposed regulations to apply only to tax-exempt organizations. (Hearings were held on November 27, 1979.) Such an action would result in different tax treatment of deferred compensation for the employee based on whether his employer was a non-profit organization or a profit-making organization. There is no rational justification for such disparate treatment. Adoption of these regulations would severely impact upon the ability of tax-exempt organizations to attract executives. Yet, the real victims are the individuals whose careers are devoted to the administration and successful operation of the nation's tax-exempt organizations.

H.R. 6824 is a responsible and reasonable bill designed to foreclose such action by the Department of the Treasury. It is imperative that Treasury not be permitted to promulgate regulations which will discard the existing long-established rules and guidelines (and ignore the long history of case law on the subject), replacing them with ambiguous unmanageable rules, which will call into serious question bona fide deferral plans. This position is amply supported by a review of the problems which will arise if the Department of the Treasury is allowed to proceed to regulate unfunded deferred compensation paid by tax-exempt organizations in a manner inconsistent with the Congressionally mandated treatment accorded private profit-making businesses.

1. The proposed Treasury regulations will violate the doctrine of forfeitability established by statutory case law

A. Code provisions

Section 1.61-16(a) of the proposed regulations states that, where a taxpayer exercises an option to defer payment of compensation, "it is immaterial that the taxpayer's rights in the amount payment of which is so deferred become forfeitable by reason of his exercise of the option to defer payment." This proposed rule is directly contrary to the "doctrine of forfeitability" which developed in common law and has been codified in relation to the realization of income by Section 83¹ and 402(b) of the Internal Revenue Code (the "Code"). If adopted, this provision will create the anomalous situation that payments to *funded non-*

¹ Section 83(a) of the Code provides as follows:

"If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of [the value of the property over the amount, if any, paid for such property] shall be included in the gross income of the person who performed the service in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable."

qualified plans will not be presently taxable to the employee if subject to forfeiture, while payments to unfunded plans (which confer a lesser economic benefit on the employee).

There are a number of reasons for our support of H.R. 6824.

First, deferred compensation plans are useless if taxable to employees. As a practical matter, employees will insist on being paid in cash if there is no tax benefit to deferral. This will reduce the availability of the funds to associations and will decrease their effectiveness in conducting the activities for which they have been granted exemption from tax. Associations which are unable to compensate executives in cash will find it difficult to attract employees.

Second, it is simply unfair to discriminate against association executives as opposed to executives of profit-making companies. The taxability of deferred compensation, as described in our written testimony, is based on constructive receipt of income—or the ability of the recipient to control income. Logically, there is no basis for any distinction between executives of associations and of companies in this respect. Both have an equal lack of control over funds which will be used to meet the employer's obligation to pay unfunded deferred compensation. Both must wait for retirement to receive the funds. Both will lose funds if the employer becomes insolvent or is otherwise unable or unwilling to meet its obligation. To discriminate in favor of corporation executives in the way proposed by the IRS is unfair and gives corporations an unjustified advantage in attracting executives.

Finally, the bill confirms present law as set forth in detail in our written testimony. The courts have been unanimous in finding nontaxable deferred compensation benefits which are forfeitable or unfunded. To allow the IRS to attempt to overrule such a large body of case law will only lead to prolonged, unnecessary and unproductive confusion and litigation.

For these reasons, we urge the Committee to recommend passage of H.R. 6824.

Mr. FOWLER. Dr. Cooper.

STATEMENT OF JOHN A. D. COOPER, M.D., PRESIDENT, ASSOCIATION OF AMERICAN MEDICAL COLLEGES

Dr. COOPER. I am John A. D. Cooper, president of the Association of American Medical Colleges, which serves as the national voice for the Nation's 126 schools of medicine, public and private, and more than 400 of the Nation's major teaching hospitals, and over 60 academic and professional societies.

I would like to say that we endorse the written statements filed in this connection by and on behalf of the National Council on Education and the National Association of Independent Colleges and Universities. For the reasons stated in those statements, as well as in this statement, we strongly urge that H.R. 6824 be adopted as presented by Congressman Cotter, with the modification that it include deferred compensation plans of State universities and colleges and their health science centers.

I will briefly talk about some of the unique parts of our written statement, which I hope will be included in the record, focused on circumstances related to medical schools and their teaching hospitals.

I would like to point out that compensation levels of management personnel in tax-exempt organizations have never been comparable to those in the taxable sector. Managing these institutions now requires the same type and caliber of people who are employed in the pharmaceutical companies, for-profit hospitals, profession corporations and other organizations in the taxable sector.

In the competition for employing these executives in the taxable sector, the Revenue Act of 1978 provides that the taxable sector can provide nonqualified deferred compensation arrangements. For the

time being, tax-exempt institutions can also offer such plans under revenue ruling 60-31, but indications are that the IRS intends to promulgate regulations that would do away with this opportunity.

We believe the inability to provide deferred compensation plans will deprive our institutions of the unusual able managers they require to operate these large and complex organizations.

For medical education there is another equally injurious side to this intention of the IRS. In addition to our institutions' managers, a number of the highest compensated and most distinguished political faculty currently hold deferred compensation plans.

We are concerned that there could be an exodus of these faculty members to professional corporations where they would accordingly either reduce or stop their involvement in teaching and research. In these corporations, of course, they have access to deferred compensation plans.

In the early 1900's, the Flexner report revolutionized American medical education which has reached a distressing level by that time. It recommended that schools engage full-time faculty in lieu of the then current practice of using outside physicians who only gave incidental teaching time to the schools.

We are concerned that the medical education deferred compensation plan will lead to a return to these unfortunate pre-Flexner days.

Of equal importance to medical education is that H.R. 6824 be extended in some way to include State universities and colleges, so that their medical schools and hospitals will be no less competitive in the recruitment of able executives, position managers, and faculty.

In our written testimony we have given a number of examples of the problems which can be envisioned for our institutions if they are denied deferred compensation arrangements.

I would like to point out that the statements that the Treasury Department made earlier today, that deferred compensation arrangements are provided in lieu of qualified funding retirement plans, is not true for our institutions. They have 403(b) retirement plans covering all of their employees, but they do require in addition deferred compensation plans to recruit and retain highly qualified and scarce administrators and faculty members.

Our institutions require the same treatment as exists for taxed organizations.

H.R. 7009

Mr. Chairman, that concludes my remarks. If there is time at the end, I would like to make a brief statement on H.R. 7009, which you cosponsored with Mr. Rostenkowski.

We are terribly concerned about the taxation of scholarships.

Mr. FOWLER. I wish, before I leave, that you would do that at this time. I was just about to ask you when you were testifying on another matter if you would care to comment on the association's position, especially with respect to the tax treatment which would be afforded the Armed Forces and the Public Health Service scholarships.

Dr. COOPER. We will submit some written testimony for the record. I am sorry that we have not submitted it at this time, and I hope that can be included in the record.

We support the part of H.R. 7009 which provides a permanent tax exemption on tuition and expenses received as a part of the Armed Forces' scholarships. We would urge the subcommittee to make the stipend tax exempt as well.

The current tax exemption on the National Research Service Award fellowships expires at the end of the year; therefore, the association would hope that H.R. 7009 could also cover the National Research Service Award fellowships as well.

These NSRA fellowships are very similar to the NSF research fellowships which do have a permanent tax exemption. Because the National Science Foundation fellowship does not have a payback provision, it is apparently considered a scholarship and therefore tax exempt. But, similarly, the NRSA fellowships are not jobs which students have, but they are fellowships, preparing them through education for careers in academic science and in the biomedical area.

Therefore, we believe that they, too, should not be taxable.

The National Research Service Award funds exempted from taxation should include tuition and stipend for the predoctoral students and \$3,600 of the stipends for postdoctoral students.

Under the schedule of the stipends that takes effect on July 1, 1980, the National Research Service Award fellows will bear a substantial tax burden unless a permanent exemption is granted.

Mr. Rostenkowski stated in his floor speech that this current exclusion of \$3,600 for postdoctoral fellows is so small that eliminating the exemption will have little impact. This is not true.

Effective July 1, 1980, predoctoral fellows will receive \$5,040 and postdoctoral fellows, depending upon their level, will receive stipends ranging from \$13,380 to \$17,040.

Under the proposal put forth in H.R. 7009, the predoctoral fellows will be harder hit than the postdoctoral fellows, since both the tuition and the stipend which is currently exempt would now be taxed.

If the NRSA stipends are not tax exempt, maintenance of income for the students, which is already at a low level for people at this level of their education, will require increases in the stipends, an action that may be possible for DOD but has been very difficult to accomplish in these other fellowship areas.

And, lastly, it is difficult already for us to attract postdoctoral physicians to consider research careers, and that, I think, is no secret to the members of this subcommittee. Unless the National Research Service Award fellowships are permanently made tax exempt, the tax will clearly act as a disincentive for physicians to consider research careers, and we are terribly concerned that over the next 10 years we may have an inadequate number of well-prepared young physicians who have had the advantage of preparation for research to carry out the Nation's biomedical research program.

Thank you.

[The prepared statement follows:]

STATEMENT OF THE ASSOCIATION OF AMERICAN MEDICAL COLLEGES

The Association of American Medical Colleges (AAMC) serves as the national voice for all of the nation's 126 schools of medicine, public and private, more than 400 of the nation's major teaching hospitals, and over 60 academic and professional societies.

The AAMC endorses the written statement filed in connection with these proceedings on behalf of the American Council on Education and the National Association of Independent Colleges and Universities. For the reasons stated therein as well as in this letter, we strongly urge that H.R. 6824 be adopted as presented by Congressman Cotter with the modification that it include deferred compensation plans of state universities and colleges and their health science centers.

Compensation levels of management personnel in tax exempt organizations have never been comparable to those in the taxable sector. Until the early 1940's this had not been a significant problem to institutions in health education because they were small and simpler to operate than they are today. The managers frequently had time to participate in research projects and/or attend to patients and teach young physicians.

During the sixties conditions changed. The institutions grew in both size and complexity. Now, in all parts of the country our health science centers have thousands of employees and annual operating budgets in the hundred million dollar range. Salaries have gone up but they are still less than those paid for equivalent effort in the taxable sector.

Managing these complex, tax exempt organizations now requires the institutions to recruit in direct competition with the taxable sector, particularly with the large corporations in the health field: pharmaceutical companies, "for profit" hospitals and management and consulting firms. Additionally the institutions face competition from professional corporations in which groups of physicians engage in the practice of medicine at compensation levels two to three times what the institutions can offer. All of these taxable entities have available and use deferred compensation arrangements to attract and maintain personnel. The Revenue Act of 1978 (Public Law 95-600) specifically provided taxable entities with this advantage. The law was silent on the applicability of such arrangements for tax exempt institutions. Due to a body of decided cases which were confirmed in Revenue Ruling 69-31, 1969-1 C.B. 174, deferred compensation arrangements exist in tax exempt institutions. Some twelve of these cases, the earliest of which was handed down in 1921, were cited in the ruling itself. The validity of the ruling, which has been in effect for nearly twenty years, has been uniformly upheld by subsequent decisions of a number of courts.

As you know, the Internal Revenue Service intends to deny these arrangements to tax exempts in spite of the ongoing series of decided cases and the obvious needs of our institutions to compete with the taxable sector for the quality managers they so desperately need.

We believe the inability to provide deferred compensation arrangements similar to those which the statute confirms can be awarded in the private sector will deprive our institutions of the unusually able individuals they require to provide the leadership now so crucial to the operation of our nation's medical colleges and teaching hospitals.

There is another equally injurious side to this intention of the IRS. Our institutions are concerned that if they are denied deferred compensation arrangements, there could be an exodus of the talented faculty who currently hold them. Many of those involved are physicians who have the available alternative of private practice in the professional corporations.

We are especially concerned at the potential loss of talented clinical faculty that is likely to result from the promulgation of the proposed regulations. In this connection, it should be noted that the Flexner Report in the early 1900's revolutionized the American medical education system which had reached a distressing state by that time in this country. One of the principal changes the Flexner Report effected is the heavy reliance that the medical schools assign to fulltime faculty for teaching. This is especially important in the clinical area where the faculty are expected to be the brightest and best: the role models that students can emulate by virtue of their renown as practitioners in a discipline or field of medicine while still deeply committed, through fulltime employment, to teaching and research. Much of the remarkable development of medicine in the United States over the past fifty years is attributable to the continuous day-to-day involvement of fulltime clinicians with students in the teaching and research of our medical colleges and associated teaching hospitals.

Our deans are gravely concerned that, if they are denied the opportunity to continue deferred compensation arrangements, many of their most talented

people will opt for the private sector and as a result be available to teaching and research only as a sideline to their primary activity—the practice of their specialty. This could have a very retrogressive and detrimental effect on medical education.

This possibility stems in part from the development of the professional corporation which is available to such practitioners and offers substantially greater financial opportunities than our institutions can provide. Moreover, in the private sector, they have available incentives, in addition to deferred compensation arrangements, which we do not provide, including much more generous pensions.

Moreover, the institutions would be faced with the significant loss of the income generated through the professional practice of those faculty members in the clinical departments, a significant part of which is used to sustain the research and educational activities of preclinical and the other operations of the medical school. This latter source of revenue has become an increasingly important factor in the support of medical schools, as the direct grants from Federal and state sources has become increasingly scarce. However, the principal effect would be upon medical education. Even if the physicians were available on a part time basis, our deans feel that it would in no way be a substitute for the present practice of employing faculty on a fulltime basis to teach, do research, perform surgery and take care of teaching cases. In sum, we believe that this change generated by the proposed IRS regulations may be irreversible and do irreparable damage to medical education, even if, as we believe, it will eventually be found to be invalid by the courts.

We would also urge that, for the purpose of deferred compensation arrangements, state universities, colleges and teaching hospitals be treated as tax exempt organizations. They are in precisely the same position as private medical schools and teaching hospitals with respect to this issue. They are in competition with private industry for especially talented individuals and should have the same opportunity to offer deferred compensation arrangements in those instances where it may be crucial to their ability to recruit such individuals for their faculty or administration.

In this connection, it should be noted that, if this is not done, there will be confusion confounded. Many state universities can and have qualified as institutions exempt under Section 501(c)(3). See *Estate of Leslie E. Johnson*, 56 TC 944 at 950 (1971), and Revenue Ruling 60-384, 1960-2 C.B. 174. Thus, many state institutions already are or could be treated as tax exempt institutions.

Moreover, as to those institutions which cannot qualify for 501(c)(3) status, Section 457 of the Code imposes strict requirements on the deferred compensation arrangements of state and local governments, providing virtually no relief in precisely those circumstances where the deferred compensation arrangement may be the crucial element in attracting qualified individuals to serve on the medical faculty. This is particularly true of those state universities and colleges (of which there are a large number) whose sole pension plan is a program of purchase of 403(b) annuities. Under these programs, the basic annuity is provided with no option on the part of the employee. Nonetheless, under Section 457, the modest \$7,500 a year limitation on deferred compensation plans of such state institutions must offset the \$7,500 with the entire 403(b) annuity payment regardless of the fact that in most cases the entire payment toward the purchase of an annuity is made with no option on the part of the employee and is the equivalent of a qualified pension plan under Section 401(a). For this reason alone we urge modification of H.R. 6824 as currently drafted since it would place state colleges and universities, including their medical schools and teaching hospitals, in the same unfair disadvantage.

Several examples might suggest the problem which the failure of H.R. 6824 to pass into law will have on the recruitment of especially gifted people for special situations. These are based upon fact situations which have existed although they do not precisely describe the circumstances involved.

(1) "A" is a clinical professor at "X" university's medical school. Although his salary reflects in some part the revenue which his clinical activity generates for the teaching hospital where he serves, it is considerably less than he could expect to realize if he were in professional corporation "M", which consists of a number of doctors, or proprietary hospital "H." Moreover, professional corporation "M" and proprietary hospital "H" have generous qualified pension plans which would afford him a pension upon his retirement, which is far greater than "X" can provide. In addition, "M" and "H", to attract "A", might be willing to

enter into a deferred compensation arrangement which would further supplement that retirement income. For a number of reasons, he would prefer to retain his status as a full professor primarily because he is a fulltime teacher and has devoted his professional life to that calling. If "X" can offer him a deferred compensation agreement, he would be happy to stay in his present capacity. If it cannot, he may well feel obliged, in the interest of protecting his family, to join professional corporation "M" or proprietary hospital "H" and do teaching on the side. Indeed, "A" and his other colleagues may determine to form their own professional corporation because the same financial considerations apply to at least some of his colleagues of the fulltime faculty at "X" university's medical school.

(2) The medical school of "Y" university is very desirous of obtaining as a fulltime professor "A", who is now teaching at "Z" state university. "A" is very interested in making the change and believes that he can make a significant contribution to "Y's" medical school program. In addition, "A's" salary will increase significantly. However, under the pension plan of "Z" state university, "A" will receive no benefits from the state retirement system other than a return on his own contributions, with modest interest. Because of the limitations of the 408(b) program maintained at "Y" university, which are based on employment with the same employer, "Y" university, which would be willing at least to bring "A's" retirement up to minimum standards, cannot do so. Only if "Y" university is able to enter into a deferred compensation agreement will "A" be able to make the change which, in the opinion of its faculty, will greatly benefit "Y's" medical teaching program. (A similar problem would exist if, as in the case of some states, "A" would be required to begin receiving retirement payments when he makes the change, albeit said retirement payments are much less than would have been available if he stayed with "Z" until his retirement.)

(3) The medical school of "X" university is desirous of persuading "A", a highly renowned doctor-scientist to become its dean. "A" who has recently resigned from a high government post has been offered a lucrative position in private corporation "M" where there is also available to him a deferred compensation program for highly compensated employees. "A" is anxious to accept the dean's post. However, not only is the compensation significantly lower than he would receive from "M" but, without a deferred compensation agreement, he will not have an adequate retirement income because of the limited number of years left for gainful employment and because of the limitations of IRC Section 408(b). "A" feels that he cannot take the employment with "X" unless he, his wife and family are adequately protected after his retirement. This is possible only if a deferred compensation agreement can be made.

(4) "A", an individual who is near retirement, is importuned to take on the task of interim dean of his institution pending the selection of a new dean, a process which may take as much as two years. Although he would like to fulfill this task, the financial benefits are so limited that he is unwilling to do so unless his retirement benefits can be significantly increased. The maximum increase from a deferred compensation arrangement will not increase his overall retirement to more than 55 percent of his present pay. The advantage to the institution of having this particular individual act as an interim dean is very great since he is intimate with the details of the institution in its operation and is acceptable to the faculty. Under these circumstances, he may feel that it simply is not to his advantage to extend his retirement for two years with all of the efforts that this involves without the benefit of deferring some of the compensation and, thus, increasing his retirement benefits.

(5) The medical school at "Y" university is particularly anxious to recruit "A", an administrator from private industry. It believes that "A's" talents will be especially beneficial to the institution in the ten years which remain of his active professional life. "A" is anxious to make this career change and thinks he can make a special contribution to "Y." However, he feels he cannot afford to do so unless he has a significant increase in his retirement benefits, some of which he may lose by leaving his present employment. In such case, he may decide that, despite his interest, he cannot really afford to take the cut in salary to assume that new obligation without some supplement to his retirement benefits.

(6) "A" is a particularly talented faculty member of "Y" medical school and is a renowned scientist. As such, he has opportunities to go into private enterprise for a significantly increased salary with excellent pension benefits which fully vest after a ten-year period under a qualified pension plan. In addition, he

will be eligible for a deferred compensation agreement which will increase those benefits so that his retirement will be 50 percent of his expected final salary at "Y" university. He wants to stay with the university and recognizes that, under its policy, the university cannot increase his salary significantly because of their fairly rigid schedule. In order to keep him, the university is willing to provide him with additional retirement benefits through a deferred compensation agreement. If such an agreement is not available, he feels that his obligations to his family are such that he must accept the new employment.

(7) "A" is an especially gifted faculty member who has demonstrated not only unusual scholarly qualities but administrative ability. He and his wife have significant current outside income which is based on a wasting asset which will not be available to him at retirement. "Y" university would like to employ him as a dean at the institution which he would like to accept. Because of his outside income, the increase in salary will not generate sufficient real income to make much difference unless he could defer a portion of the compensation and apply it towards his retirement which will otherwise be relatively modest. In the absence of such a program, he may decide not to undertake the arduous administrative tasks which the new position requires as compared to his present activities.

For these reasons and for the reasons set forth in the statement of the American Council on Education and the National Association of Independent Colleges and Universities, we urge modification and passage of H.R. 6824.

STATEMENT OF EUGENE J. McDONALD, ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES, AND THE AMERICAN COUNCIL ON EDUCATION

Mr. McDONALD. My name is Eugene McDonald, and I am vice president and general counsel of Duke University. I appreciate the opportunity to appear before this distinguished subcommittee on behalf of the National Association of Independent Colleges and Universities and the American Council on Education, whose membership includes over 1,600 public and independent colleges and universities.

H.R. 6824, which is the subject of this hearing, would clarify the status of deferred compensation arrangements for tax-exempt organizations. We welcome this clarification and fully support the approach embodied in Mr. Cotter's bill.

I would like to comment on the Treasury's failure to sustain its burden of proving the need for the highly selective and discriminatory regulations it proposed, and to demonstrate that we have a need for the Cotter bill to preserve the status quo.

My comments will also illustrate the importance of the status quo, permitting the use of nonqualified deferred compensation plans to exempt organizations and tax paying organizations so that they are on the same basis.

This parity is important to colleges and universities in particular. This, again, underscores the need for the Cotter bill to preserve the status quo.

Without statutory clarification of the status of tax-exempt plans, the Department of the Treasury will likely impose on these organizations regulations identical to those that Congress in the Revenue Act of 1978 explicitly rejected for plans maintained by for profit and public employers.

The proposed Treasury regulations, now limited to tax-exempt organizations, would reverse longstanding rules in this area. The rules for nonqualified deferred compensation arrangements are contained in Revenue Ruling 60.31. This ruling, crafted over 20 years ago, was

itself based on substantial judicial precedents, some 12 of which were cited in the ruling.

The validity of this ruling has been uniformly upheld by subsequent decisions of the various courts.

We respectfully suggest that the burden of proof requiring change in this matter is on the Treasury, to put forth an adequate justification for overturning these well-established rules. No abuses of tax-exempt plans have been cited by the Department.

Congress demanded solid justification before allowing changes in the rules governing deferral arrangements of public employees. In that case, Treasury made a showing that in a substantial number of cases deferred compensation plans were being used improperly as a substitute for broad-based retirement programs.

No such problem has, or even could, arise with the deferred compensation plans or tax-exempt organizations. These plans, like those of for-profit corporations, which they are most closely akin to, are subject to ERISA rules which, in effect, limit the availability of deferral arrangements to highly compensated employees and independent contractors.

Treasury's principal rationale for suggesting a reversal of the rules for tax-exempt organizations is that there is a potential for abuse in exempt plans. This potential for abuse, Treasury argues, does not exist in for-profit plans. Hence, there exists a basis for distinguishing between these plans.

The Treasury theory is based on the premise that since private employers must forego a current tax deduction under deferred compensation arrangements, taxable employers will be dissuaded from establishing such arrangements as a general rule.

There is, however, no evidence that this tax tension in the corporate world serves as a deterrent. In fact, for accounting purposes, corporations treat deferred compensation as a current expense and the related increase in tax liability as representing a prepaid expense.

Thus, for purposes of the corporate financial statement, the promise of deferred compensation generally has the same effect on after-tax earnings as current compensation payments. Beyond the seeming lack of validity of Treasury's tax-tension argument, there is the fundamental point that Treasury, while speaking of potential abuses, has yet to demonstrate serious abuses exist.

Although Treasury lacks a rationale for suggesting that decades of precedent be overturned, its formulation of a proposed solution raises more serious questions.

Committee hearings in conjunction with the Revenue Act of 1978 explored the administrative unworkability and complexities of these regulations. These defects remain.

In addition, the more narrowly targeted coverage of the currently proposed regulations raise new and fundamental policy questions because of the selective nature of such coverage.

The net effect of the proposed Treasury regulations is to create one measure of income for employees of tax-exempt organizations and a different measure of income for similarly-situated employees in the private, for-profit sector. For sound reasons, employer-based distinctions have traditionally been disfavored by the Service unless there has been a compelling justification.

The soundness of this position is demonstrated by the inequalities that use of employer-based distinctions produce for the individual employee taxpayers. For example, the very essence of the cash basis of accounting which most taxpayers use is that there is no taxable event until income is received or otherwise made available. But the proposed regulations would require the payment of a tax currently when funds have not yet been received by the taxpayer.

Thus, the employer-based distinction in the regulation would interfere with the statutory right of nonprofit employees to report compensation income, utilizing this popular method of accounting.

It should be noted that deferred compensation arrangements are not now widely used in higher education; yet that limited usage bears an inverse relationship to the potential importance and practical significance of these arrangements.

The availability of such a mechanism to institutions of higher education in flexibly tailoring compensation agreements to the individual needs of key personnel can quite literally be determinative of the institution's ability to recruit in some instances.

There are at least three separate situations I will highlight where deferred compensation arrangements can prove important to institutions of higher education in competing for needed talent, and these will be described below.

The most frequent use of these financial arrangements is in competition with private industry for executive talent to staff and lead our institutions. Indeed, one of the most troubling aspects of our plight should Congress not act and the proposed regulation take effect is the inarticulated premise stated, that tax-exempt institutions need not compete for the best talent available.

We know that in other contexts—the unrelated business income area, for example—Congress has legislated and the Service has regulated out of concern that tax-exempt institutions not be allowed to use their status unfairly to compete with commercial enterprise. But in the case of the proposed regulation the unfair competition theory would be cruelly and irrationally turned on its head, and tax-exempt institutions would be unfairly disadvantaged in their legitimate need to compete with industry for top talent.

The truth is, higher education does need to compete. The Government and the courts surely do not look on universities as any less responsible than the profitmaking sector for accommodating the myriad new regulatory requirements imposed upon them in the last decade.

In addition, the publicized economic stresses of higher education institutions, caused both by our troubled economy and by changing demographic patterns, place a premium on attracting in far greater numbers than in the past talented individuals possessing demonstrated managerial skills.

In truth, the times ahead will require a mix of leadership skills far different than was necessary for past survival and prosperity. Thus we will need increasingly to compete both directly and vigorously with American industry for a limited pool of outstanding executive leadership if we are to maintain and increase our contributions to American society.

Economically, we already are at a significant disadvantage in such competition for top leadership now; we do not have a growing earnings base enabling us to pay high executive salaries, nor an opportunity to provide stock options or other future-enhancing fringe benefits.

In fact, according to the 1977-78 Administrative Compensation Survey by the College and University Personnel Association, inflation has also taken a heavy toll. The survey shows that chief executives at colleges and universities have received only a 9.4-percent increase in their median salary since 1975-76.

Surely, therefore, there can be no basis for widening the competitive gap further by refusing us the selective use of tax-deferred compensation arrangements as a needed weapon in our competitive quest for the ablest administrative talents.

There is a second and similar situation in which tax-deferred compensation arrangements have been important. Higher education in the last decade has been the beneficiary of corporate deferred compensation plans by obtaining needed managerial skills through the employment of corporate executives at or near retirement.

Such individuals invariably have done substantial tax planning, which in many cases includes private deferred compensation arrangements. As a result, they are frequently willing to work for universities at compensation rates below their market value.

However, the other attractions of college or university employment are usually lessened without tax-favorable opportunities to further defer compensation for their future income requirements when fully retired. The flexibility offered by deferred compensation plans can be decisive in obtaining their services.

A third situation in which deferred compensation arrangements become important involves the competition for key individuals within the higher education system.

I will cite one recent example involving my university's effort to recruit a distinguished senior professor from another institution: The faculty retirement plan at that institution would require the professor in question, as a practical matter, to start drawing his taxable retirement benefits if he left that university after age 55 to accept other employment. In this circumstance, and without the opportunity to tailor a deferred compensation arrangement to that professor's special present and future income need, there is no feasible way in which we can realistically compete for his services.

As a result, the unique benefits he could bring to our institution and its programs were jeopardized.

Finally, we would note that deferred compensation arrangements offer important financial benefits to hard-pressed university employers. The obligation to pay out the funds in the future with cheaper dollars, even where the employer sets aside those funds, is often less than the obligation to pay out of current funds. In this connection, inflation plays an important role in lessening those obligations.

Nor should there be any concern with "double-dipping" because of the availability of the limited deferral mechanism of section 403(b). It is recognized that these tax deferred annuities are very important to faculty and staff members in general, but for the very few execu-

tives who are suitable for individualized deferred-compensation arrangements, section 403(b) limits will not always be adequate.

No individual is in any sense receiving a double benefit; the institution merely has available two deferral mechanisms: one, subject to percentage and dollar limitations, maybe offered to all employees. These are broadly available for the sound reasons underlying the enactment of section 403(b).

The other, without such limits, is appropriate for only certain key executives, now very few in number but inevitably increasing, we feel, as the complexities and demands of change are felt and responded to by our institutions.

To conclude, we believe that for the Internal Revenue Service to take up arms against the deferred compensation spectre in the limited arena of tax-exempt arrangements is a game not worth the candle. Whatever defects the Service may perceive in deferred compensation arrangements, the discriminatory application of special rules to the employees of tax-exempt organizations alone cannot be justified and would risk damage to these institutions far greater than any perceived benefits to the public treasury.

For the reasons stated, we strongly endorse a statutory clarification of this matter.

We respectfully request that the text of this statement be included in the official record of this hearing.

Mr. GUARINI [presiding]. Thank you.

I would call on Mr. Martin D. Wood, director, Retirement, Safety, and Insurance Department of the National Rural Electric Cooperative Association, NRECA.

We welcome you, Mr. Wood, and we appreciate your statement.

STATEMENT OF MARTIN D. WOOD, DIRECTOR, RETIREMENT, SAFETY AND INSURANCE DEPARTMENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Wood. I thank the committee for the opportunity to appear.

The association, NRECA, as you probably know, is a trade association, representing 1,000 cooperatives throughout the country in some 46 States, which bring power to over 25 million consumers.

I have prepared a written statement, which I request be placed in the record; but for reasons of time I would simply like to summarize some of the important points. I will only address those points which have to do with the bill itself.

The association provides a full package of benefits for employees of rural electric cooperatives throughout the country. These include both pension benefits of a defined benefit nature and a defined contribution nature, and also, since 1967, a deferred compensation availability.

In the Revenue Act of 1978, Congress acted to insure the continuation of past deferred compensation treatment for employees of private taxable employers, but not for employees of nonprofit organizations.

Benefit programs for rural electric cooperatives, as well as for all tax-exempt organizations, fall within the definition and consideration

of private sector plans. Deferred compensation, therefore, should be treated similarly.

Benefits are an important part of the overall package to attract and retain competent management. Due to their nonprofit status, rural electric cooperatives cannot offer management incentives such as stock options and profit-sharing plans; therefore, deferred compensations is an extremely important management incentive, one which the cooperatives must have to successfully compete for good management.

In summary, NRECA believes in that for the purpose of deferred compensation, all tax-exempt employees should be treated as are private sector employees.

Thank you.

Mr. GUARINI. Thank you, Mr. Wood.

[The prepared statement follows:]

STATEMENT OF MARTIN D. WOOD, DIRECTOR, RETIREMENT, SAFETY, AND INSURANCE
DEPARTMENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Chairman and Members of the Subcommittee, I am pleased to appear before you today representing the employees of the rural electric cooperatives and their associations concerning H.R. 6824, a bill to preserve the application of existing law to nonqualified deferred compensation arrangements maintained by tax-exempt organizations. The National Rural Electric Cooperative Association (NRECA) is the trade organization of the more than 1,000 rural electric systems located in 46 states and serving central station electricity to 25 million consumers.

As part of its activities on behalf of these member cooperatives, NRECA administers a series of fringe benefit programs including a qualified savings program, group life insurance, group accident, medical and hospitalization insurance, and deferred compensation. As with NRECA membership itself, participation in one or more of these programs is entirely optional for the individual member cooperative. Approximately 900 employees of 350 NRECA member cooperatives have chosen to participate in the deferred compensation program which we have made available to them since 1967.

The entire matter of the treatment of deferred compensation programs became uncertain when the Treasury Department on February 3, 1978 published a ruling that would have effectively ended deferred compensation arrangements by declaring income taxable the year earned rather than the year received. At that time NRECA took the position that there had been no change in the law or court decisions to warrant the proposed rule change. The mere promise of the employer to pay a sum of money to the employee at a future date did not constitute compensation and was incapable of valuation. We felt the proper forum for such discussion was in Congress, not the Executive branch.

In 1978 the Senate Finance Subcommittee on Private Pension Plans and Employee Fringe Benefits held hearings on S. 2627, a bill protecting deferred compensation plans for units of State and local government. At that time NRECA presented testimony asking that the protection for continuance of such plans be extended to a broader class of employee. NRECA argued that the IRS regulations eliminated this employment benefit for all participants regardless of employer-type and that Congress ought to protect the right of participation for all employees, not solely government employees.

In the Revenue Act of 1978, Congress acted to insure continuation of past deferred compensation program treatment for employees of private, taxable employers. During Senate consideration NRECA endeavored to have rural electric cooperative employees and employees of tax-exempt organizations generally, included in the private employer section with the other non-governmental entities. Although this effort was not upheld during the House-Senate conference, our rationale then, stands today:

1. Benefit plans for rural electric cooperatives, as well as for tax-exempt organizations, fall within the definition and consideration of private sector benefit plans. These programs include pension, savings and insurance. Deferred compensation, in our opinion, should, therefore, be treated similarly.

2. Employee benefit packages are a tool used to attract and retain qualified, competent management employees. This is especially true for industries such as electric utilities. According to *Electrical World* (October 15, 1979, page 33), citing a study conducted by the Arthur Young Company, "utility executives ranked last in compensation among 22 major industries studied 'primarily because of policies against bonuses'." In addition to this bias, the article cites "continual potshotting" by rate intervenors as another salary depressant. Finally, contributing to the dilemma peculiar to rural electric management recruitment, due to their non-profit status, rural electric systems necessarily cannot offer management incentives such as stock option and profit-sharing plans. Therefore, deferred compensation agreements are one of the few management incentive tools available to the rural electric portion of the electric utility industry.

3. Like other tax-exempt employers, rural electric cooperatives negotiate with their employees over wages, salaries, terms and conditions of employment just as employees of other private sector organizations. Benefit plans and salaries are not fixed as in the public sector.

4. One of the terms of any deferred compensation plan is that the agreement itself constitutes no more than an unsecured promise to pay a sum of money at a later date and is subject to the subsequent solvency of the employer. Employees of any tax-exempt organization are in danger of forfeiting their deferred compensation if the employer faces insolvency. Any deferred compensation claim against the employer's assets rests on no firmer ground than those of other creditors.

NRECA does not accept the "tax tension" argument that has in the past been forwarded by the Treasury Department. That is, the taxable employer cannot deduct, from taxable income, funds placed into a deferred compensation program. This fact, Treasury asserts, serves as a restraint on the amount that the private sector employers will allow their employees to defer. NRECA suggests that any such restraint, if it indeed exists, is more than offset by the generally higher salary levels of employees in the private sector who are likely to defer income. Further, many large private sector businesses enjoy special tax advantages that reduce corporate tax liability to the point that the restraint to which Treasury refers would be minimal.

Employees of electric cooperatives do not receive compensation of a magnitude equivalent to that paid top level business executives in the United States, or anything close to that magnitude. Yet, deferred compensation is indeed an important element in the long term financial planning of our management employees, and an important benefit which will supplement fixed income retirement plans on which such employees must depend at the end of their working careers.

In summary, Mr. Chairman and Members of the Committee, NRECA believes that for the purposes of deferred compensation, all tax-exempt organization's employees should be treated as are private-sector employees.

Mr. GUARINI. Do any of you gentlemen know, or—actually there is no cost to the Government, because this is allowed right now by administrative rulings, so what we are actually doing is just asking to make it statutory so there will be no questions about it in the future.

I think you gentlemen made your point clear, and I have no problem with the concept, and I want to thank you for testifying and giving us your opinions. Your report will be entered in the record.

Do you think it is possible to have a different standard? I am just wondering, do you in your experience find that this is a very difficult area in getting people of high quality to enter the educational field?

Mr. McDONALD. That is to say without the availability of this?

Mr. GUARINI. Yes. Certainly, people who go to colleges do it by their own choice, because that is their profession and this is the thing that they believe in, and it is a commitment of dedication and ministry, if you will.

Now, do you think that there is more emphasis put onto the argument that the law is basically unfair if you treat business different than you treat the educational institutions, or do you feel that it

really, truly, is a loss of the competitive edge in getting good talent in the university?

Mr. McDONALD. As a lawyer, I subscribe to the former. I think the inequities are unconscionable and can't be justified.

Mr. GUARINI. I agree with that.

Mr. McDONALD. As an administrator in a university only belatedly, I have come to realize how forceful is the second argument. It is a very, very important factor. The point I would like to leave with this committee is that in my perception it will become extraordinarily more important in the difficult decades ahead, when colleges and universities absolutely must recruit to their leadership ranks the highest kinds of talent that now otherwise would be more inclined to gravitate toward industry, to allow colleges and universities competitive parity with industry, so they might offer good candidates some kind of a beneficial edge, in addition to the mission they might equate with serving in the ranks of colleges and university administrators.

Dr. COOPER. May I just add that this situation that Mr. McDonald has talked about is particularly severe in our medical schools and teaching hospitals, where we cannot and do not, or are not able to, compete with the incomes that physicians can make on the outside.

For the very highly talented and highly skilled managers and professionals, the faculty members and surgeons and internists and so, without deferred compensation there is a great threat that for a selected few we will lose them out into professional organizations and as a result will not have these people available for the teaching and research, which are critical to improving the health of this country.

Mr. GUARINI. I can see the medical doctors have their options open and they can go into the field of medicine if not teaching.

Dr. COOPER. That is right.

Mr. GUARINI. I thank you very much.

The next witness is Mr. John Olshaker, co-coordinator of the legislative affairs task force of the American Medical Student Association.

STATEMENT OF JOHN OLSHAKER, CO-COORDINATOR, LEGISLATIVE AFFAIRS TASK FORCE, AMERICAN MEDICAL STUDENT ASSOCIATION; ACCOMPANIED BY ROCIO HUET, PRESIDENT, AND BRADFORD BEEBE, STUDENT AT GEORGE WASHINGTON UNIVERSITY

Mr. OLSHAKER. My name is John Olshaker and I would like to share my time with two other members of AMSA. Miss Rocio Huet, our president, and Bradford Beebe, who would also like to talk on the subject, and I will try to do this quickly.

ASMA strongly supports the purpose of these programs and we have done so for many years. We have played a big role, we think, in helping to develop different programs in the National Health Service Corps and the military. We believe these programs are important. They are important both for the public, and as a means for people to go into medicine and have a variety of options without having to worry about major, long-term debts to pay back.

Again, we think these are very important.

If there is no tax exemption for the majority of the scholarships or the entire scholarships, we think this will prove a strong disincentive to people going into the programs.

I am speaking as a member of AMSA, and I am also speaking as a person who is in the Navy scholarship program. I live in Washington, D.C., and go to school here. As it stands now, I am considered under the temporary moratorium for taxes for military scholarship. The stipend I get is not even enough to meet living expenses in this city, and that is without taxation.

In the tables in the back of our written testimony, we have shown a variety of different types of schools and the major impact the taxation would have on students in the programs. It would force them to borrow what we consider considerable sums of money at this time to pay the taxes.

This for many, many people would be a strong disincentive to going into the program.

In summarizing my comments before I let Rocio talk, again let me stress we think these are very important programs, both for us as medical students and for the whole health care delivery system.

We urge the strong continuation of these programs and we would be remiss if we did not say that we would like permanent tax exempt status for the entire scholarship stipend and expenses. But we think that this bill, H.R. 7009, is a very good compromise for our purposes and for the purposes of the public; and we urge your support.

Also let me say AMSA is an independent organization, representing over 23,000 medical students, and well over 100 chapters.

Let me also say we appreciate Dr. Cooper's comments and we share his opinions thereon.

Ms. HUET. I am Rocio Huet, a fourth-year medical student at the University of Michigan, now on leave of absence for 1 year to fulfill the office of the president of the American Medical Students Association, AMSA.

Again, I would also like to thank you for the opportunity to testify here today.

As John stated, and as you know, the intent of the legislation which created the National Health Service Corps Scholarships and the Armed Forces health professional scholarship program, was to provide health services to medically underserved areas.

In the past, health professionals would gravitate to the more lucrative specialties in urban areas. As a result of this, it precipitated the need for these scholarship programs. Those medical students most likely to return to underserved areas are minority and lower-income students, along with other students who are also deeply committed to providing service in those underserved areas.

The lower-income students and minorities, who are predominantly lower income, and those committed individuals at very high tuition schools regardless of their commitment to practice in underserved areas, have only two choices: to assume a burdensome level of indebtedness or participate in a service scholarship program. The choice seems simple enough, if, in fact, the goals of the scholarship program are consistent with the individual's goals.

But the scholarship, if it were taxed, would force two choices to be made, and the choices would actually come down to (1) financing an education totally through loans and owing \$40,000 to \$60,000, but nevertheless still being able to choose a full range of specialties and location of practice; or (2) owing 4 years of service with limited career

specialties and still needing to borrow substantial sums to pay the living expenses.

There is a chart in the back on one of the medical schools that is mostly minority. If you were to look at the differential in costs, you would see that students would be in essence taking up all of their living expenses and would still have to borrow in order to be able to finance their education and live.

Given these choices, students will not choose to participate in the scholarship programs, and that will result in fewer health professionals.

I would like to say as a Chicano, myself, that less than 10 percent at the moment of medical students in this country are minority students, and yet over 25 percent of scholarship recipients in this country come from those groups.

If taxation were to consume all of our scholarship stipend and because loans are limited not only for all medical students but also especially for minority students, then we would see a decrease in the number of minorities in the Public Health Service and National Health Service Corps. But I think even more alarming, we are going to see a great decline in the number of minorities in medical school itself.

As John said, AMSA still believes that these scholarships should be totally exempt from personal income tax, but we as students can support what we consider a compromise through H.R. 7009, which would permanently exempt the tuition, books, equipment, and fees portion of these scholarships from personal income tax, but would consider the living stipend portion of these scholarships taxable.

But it is our further hope that if, in fact, these living expenses are taxed, appropriate committees would consider increasing the living stipend to an amount commensurate to any taxes levied.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN MEDICAL STUDENT ASSOCIATION

As you know, Congress has taken repeated action to exempt National Health Service Corps Scholarships and Armed Forces Health Professions Scholarships from personal income tax on the principle that, taxation of these scholarships would undermine the intent of the legislation which created these programs to meet the pressing need for health manpower in medically underserved areas and in the Armed Forces. The legislation was also intended to enable students, especially those from ethnic minorities and low income backgrounds, to afford the high costs of medical and dental schools which are particularly high for those attending private schools or who are out-of-state residents at public schools.

HR 7009 would effect a compromise which would permanently exempt the tuition, books, equipment and fees portion of these scholarships from personal income tax, but would consider the living stipend portion of these scholarship taxable, as a permanent ruling.

I would be remiss if I did not mention that those students who would be most adversely affected by the taxation of the living stipend are those students who are most heavily dependent upon it, especially students from ethnic minorities or low income backgrounds, because day-to-day living expenses are as much a part of educational costs as are tuition, books, fees and equipment. Thus it is my further hope that the appropriate committees consider increasing the living stipend to an amount commensurate to any taxes levied against the living stipend.

While it remains our firm belief that the AFHPSP/NHSC Scholarships should be exempt from personal income tax in their entirety, HR 7009 would effect a compromise position that we the students support.

(EXHIBIT)

SUMMARY ARGUMENTS SUPPORTING EXEMPTION

1. These programs are a vital component of important social and congressional goals

In 1972, Congress recognized the urgent need to attract health professionals to the Armed Forces and to medically underserved America. Congressional response was in the form of the Uniformed Services Health Professions Revitalization Act of 1972 (Public Law 92-426) and the Emergency Health Personnel Act Amendments of 1972 (Public Law 92-585) which authorized the AFHPSP and PHS/NHSC scholarship programs, respectively. The success of the PHS/NHSC program in locating and retaining health professionals in medically underserved areas is evidenced by continued expansion of the NHSC scholarship program authorized by Public Law 94-484. This is one of the few programs whose funding is increased in the President's fiscal year 1981 budget recommendations. With Congressional aspirations of eventually obligating 25-50 percent of every medical school class to service, these scholarships are seen as the primary mechanism for correcting existing and projected physician shortages in the Armed Forces and in certain rural and urban areas.

The Conference Report to Public Law 94-484 indicated that "the principal purpose of awarding NHSC scholarships is to provide health services to medically underserved areas and not simply to provide financial support or health professions students." (H. Rep. 94-1612, p. 106). Because these scholarships were created to insure adequate medical staff for the Armed Forces and health services for underserved populations, the principal beneficiaries of these programs are the American people/taxpayers themselves.

2. The effect of taxation on these scholarship programs would be substantial and would impact disproportionately on low-income and minority students

Taxation of the full scholarship, including monies for tuition books, fees, equipment and living expenses would reduce the amount of scholarship such that virtually no stipend would be left for living expenses. Congress intended however, that these scholarships provide for education and living expenses, as evidenced by the stipulation that the NHSC stipend keep pace with inflation through increases commensurate with General Schedule cost-of-living adjustments (section 751(g)(3) of Public Law 94-484). Thus, the effect of taxation is to subvert Congressional intent.

In the past, health professionals gravitated toward the more lucrative subspecialty practices in urban areas. This precipitated the need for the PHS/NHSC scholarship program. Upper income students will have the financial means to afford the kind of training, practice and locals they desire. Lower income students, predominantly minorities, and students at high tuition schools must either assume burdensome levels of indebtedness or participate in a service scholarship program. In deciding between financing their education totally through loans and owing \$40-\$60,000 with no strings attached as compared with owing four years of service with limited career specialty choices and still needing to borrow substantial sums to pay their living expenses, students will choose not to participate in these scholarship programs. This choice will result in fewer participants in the scholarship programs and, consequently, fewer health professionals being sent to the Armed Forces and underserved America.

The significance of taxation becomes readily apparent when one considers the types of students that normally participate in these scholarships. Scholarship students, for the most part, fall into one of three categories: students at high tuition schools, students of low-income/minority status and students with a genuine and deep commitment to service. For example, while only about one of every ten medical students is Black, Hispanic or Native American, one of every four scholarship recipients is of minority heritage. Minority students, if taxation consumes all of their scholarship stipends, may not even be able to borrow enough to meet living expenses since their sources of loan funds are limited. Thus, taxation impacts disproportionately on the low-income/minority student—the same group representing the majority or recent declines in medical school applicants. The typical scholarship recipient is not of substantial means and in search of added sources of sheltered income.

[Apr. 11, 1980]

	Medical schools	Enrollment	Average of tuition and fees	
Medical schools in the United States:				
Private.....	51	25,515	\$7,135.	
Public.....	74	38,192	Resident: \$2,214/nonresident: \$4,117.	
Total.....	125	63,707	Not available.	
		Areas	Population of areas	Practitioners needed
Health manpower shortages, by areas (primary care):				
Urban areas.....		484	18,975,337	5,968
Rural areas.....		1,226	18,622,289	5,368
Total areas.....		1,710	37,597,626	11,336
				Total
Scholarship aid:				
National Health Service Corps.....				5,695
Public schools.....				(2,310)
Private schools.....				(3,385)
Armed Forces health professions scholarships.....				3,548
Public schools.....				(2,181)
Private schools.....				(1,367)
Available Public Health Service budgeted positions.....				732

Number of dental schools in the U.S.A.:	
Public.....	36
Private.....	23
Total, all dental schools.....	59
Dental School enrollment:	
Public.....	13,333
Private.....	9,102
Total, all dental schools.....	22,435
Dental school tuition:	
Public ¹	\$3,324/\$4,264
Private.....	5,939
Number of dental students with Public Health Service Scholarships:	
Public schools.....	241
Private schools.....	332
Total.....	573
Public Health Service need for dentists.....	2,848
U.S. areas with need for dentists:	
Urban areas.....	137
Rural areas.....	724
Total, all U.S. areas.....	861

¹ Resident/Nonresident.

Northwestern (private)—single student

Income		Expenses	
Tuition.....	7,260	Monthly stipend.....	429
Stipend.....	5,148	Monthly taxes.....	190
Educational expenses.....	700		
Total taxable income.....	13,108	Amount remaining each month for living expenses.....	238
Taxes		Projected monthly living expenses.....	421
Federal.....	1,957		
State.....	328	Deficit/surplus.....	-183
Total taxes.....	2,285		

Summary.—This student would need to borrow \$183 per month or \$2,196 per year in order to meet expenses.

Married student—spouse employed and no children

<i>Income</i>		<i>Expenses</i>	
Tuition	7,260	Monthly stipend & salary	845
Stipend	5,148	Monthly taxes	240
Educational expenses	700		
Spouse's salary	5,000	Amount remaining each month for living expenses	605
Total taxable income	18,108	Projected monthly living ex- penses	703
<i>Taxes</i>		Deficit/surplus	-98
Federal	2,436		
State	453		
Total taxes	2,889		

Summary.—This couple would need to borrow \$98 per month or \$1,176 per year in order to meet their expenses.

Married student—spouse not employed and one child

<i>Income</i>		<i>Expenses</i>	
Tuition	7,260	Monthly stipend	429
Stipend	5,148	Monthly taxes	136
Educational expenses	700		
Total taxable income	13,108	Amount remaining each month for living expenses	293
<i>Taxes</i>		Projected monthly living ex- penses	816
Federal	1,305	Deficit/surplus	-523
State	328		
Total taxes	1,633		

Summary.—This couple would need to borrow \$523 per month or \$6,276 per year in order to meet their expenses.

University of Illinois (Chicago Circle) (public)—single student

<i>Income</i>		<i>Expenses</i>	
Tuition	2,300	Monthly stipend	429
Stipend	5,148	Monthly taxes	83
Educational expenses	500		
Total taxable income	7,948	Amount remaining each month for living expenses	346
<i>Taxes</i>		Projected monthly living ex- penses	425
Federal	795	Deficit/surplus	-79
State	198		
Total taxes	993		

Summary.—This student would need to borrow \$79 per month or \$948 per year in order to meet expenses.

Married student—spouse employed and no children

<i>Income</i>		<i>Expenses</i>	
Tuition	2,300	Monthly stipend and salary.....	845
Stipend	5,148	Monthly taxes.....	132
Educational expenses.....	500		
Spouse's salary.....	5,000	Amount remaining each month	
		for living expenses.....	713
Total taxable income.....	12,948	Projected monthly living ex-	
		penses	670
<i>Taxes</i>		Deficit/surplus	+43
Federal	1,265		
State	323		
Total taxes.....	1,588		

Summary.—This couple would not need to borrow any money.

Married student—spouse not employed and one child

<i>Income</i>		<i>Expenses</i>	
Tuition	2,300	Monthly stipend.....	429
Stipend	5,148	Monthly taxes.....	38
Educational expenses.....	500		
		Amount remaining each month	
Total taxable income.....	7,948	for living expenses.....	391
		Projected monthly living ex-	
		penses	769
<i>Taxes</i>		Deficit/surplus	-379
Federal	261		
State	198		
Total taxes.....	459		

Summary.—This couple would need to borrow \$379 per month or \$4,548 per year in order to meet their expenses.

Meharry (private) (minority)—single student

<i>Income</i>		<i>Expenses</i>	
Tuition	4,525	Monthly stipend.....	429
Stipend	5,148	Monthly taxes.....	155
Educational expenses.....	500		
		Amount remaining each month	
Total taxable income.....	10,173	for living expenses.....	274
		Projected monthly living ex-	
		penses	393
<i>Taxes</i>		Deficit/surplus	-119
Federal	1,260		
State	610		
Total taxes.....	1,870		

Summary.—This student will need to borrow \$119 per month or \$1,428 per year in order to meet expenses.

Married student—spouse employed and no children

<i>Income</i>		<i>Expenses</i>	
Tuition	4,525	Monthly stipend and salary	845
Stipend	5,148	Monthly taxes	221
Educational expenses	500		
Spouse's salary	5,000	Amount remaining each month for living expenses	624
Total taxable income	15,173	Projected monthly living ex- penses	555
<i>Taxes</i>		Deficit/surplus	+69
Federal	1,745		
State	910		
Total taxes	2,655		

Summary.—This couple would not need to borrow any money.

Married student—spouse not employed and one child

<i>Income</i>		<i>Expenses</i>	
Tuition	4,525	Monthly stipend	429
Stipend	5,148	Monthly taxes	105
Educational expenses	500		
Total taxable income	10,173	Amount remaining each month for living expenses	324
<i>Taxes</i>		Projected monthly living ex- penses	665
Federal	653	Deficit/surplus	-341
State	610		
Total taxes	1,263		

Summary.—This couple would need to borrow \$341 per month or \$4,096 per year in order to meet expenses.

University of Tennessee Center for Health Sciences (public)—single student

<i>Income</i>		<i>Expenses</i>	
Tuition	\$1,496	Monthly stipend	\$429
Stipend	5,148	Monthly taxes	101
Educational expenses	1,100		
Total taxable income	7,744	Amount remaining each month for living expenses	328
<i>Taxes</i>		Projected monthly living ex- penses	400
Federal	757	Deficit/surplus	-72
State	464		
Total taxes	1,221		

Summary.—This student will need to borrow \$72 per month or \$864 per year in order to meet expenses.

Married student—spouse employed and no children

<i>Income</i>		<i>Expenses</i>	
Tuition	1,496	Monthly stipend and salary	845
Stipend	5,148	Monthly taxes	165
Educational expenses	1,100		
Spouse's salary	5,000	Amount remaining each month for living expenses	680
Total taxable income	12,744	Projected monthly living ex- penses	627
<i>Taxes</i>		Deficit/surplus	+53
Federal	1,225		
State	764		
Total taxes	1,989		

Summary.—This couple will not need to borrow any money.

Married student—spouse not employed and one child

<i>Income</i>		<i>Expenses</i>	
Tuition	1,496	Monthly stipend	429
Stipend	5,148	Monthly taxes	58
Educational expenses	1,100		
Total taxable income	7,744	Amount remaining each month for living expenses	371
<i>Taxes</i>		Projected monthly living ex- penses	737
Federal	229	Deficit/surplus	-366
State	464		
Total taxes	693		

Summary.—This couple would need to borrow \$366 per month or \$4,392 per year in order to meet their expenses.

George Washington University (private) (high tuition)—single student

<i>Income</i>		<i>Expenses</i>	
Tuition	11,900	Monthly stipend	429
Stipend	5,148	Monthly taxes	363
Educational expenses	850		
Total taxable income	17,898	Amount remaining each month for living expenses	66
<i>Taxes</i>		Projected monthly living ex- penses	520
Federal	3,317	Deficit/surplus	-454
State	1,043		
Total taxes	4,360		

Summary.—This student would need to borrow \$454 per month or \$5,448 per year in order to meet expenses.

Married student—spouse employed and no children

<i>Income</i>		<i>Expenses</i>	
Tuition	11,900	Monthly stipend and salary----	845
Stipend	5,148	Monthly taxes	396
Educational expenses	850		
Spouse's salary	5,000	Amount remaining each month for living expenses	449
Total taxable income	22,898	Projected monthly living ex- penses	700
<i>Taxes</i>		Deficit/surplus	-251
Federal	3,689		
State	1,060		
Total taxes	4,749		

Summary.—This couple would need to borrow \$251 per month or \$3,012 per year in order to meet their expenses.

Married student—spouse not employed and one child

<i>Income</i>		<i>Expenses</i>	
Tuition	11,900	Monthly stipend	429
Stipend	5,148	Monthly taxes	266
Educational expenses	850		
Total taxable income	17,898	Amount remaining each month for living expenses	163
		Projected monthly living ex- penses	784
<i>Taxes</i>		Deficit/surplus	-621
Federal	2,186		
State	1,007		
Total taxes	3,193		

Summary.—This couple would need to borrow \$621 per month or \$7,452 per year in order to meet expenses.

* (Based on 1978 cost figures and tax schedule.)

[From the Washington Post, Mar. 13, 1980]

BONUS BILL VETOED—PENTAGON FEARS EXODUS OF DOCTORS

Defense officials say they fear a hemorrhage of doctors from the armed services unless Congress quickly sends President Carter new bonus legislation to replace a bill he vetoed.

"We'll be in serious trouble if something isn't done," said a key civilian official who declined to be named.

"We may be in for some rough weather without enough incentives to keep our doctors on board," said a senior Navy official.

Carter said "a number of flaws" prompted his veto Tuesday, leaving open the possibility he might sign a substitute bill if Congress does corrective surgery.

The House sent the bill back to the Armed Services Committee yesterday rather than try to override the veto.

Pentagon officials indicated they probably will ask Congress to draft a new measure that would satisfy the president.

Carter objected to what he called the "unduly generous" bonuses provided in the bill he vetoed. The measure would allow bonuses and extra pay totaling about \$28,000 a year, nearly double the current \$16,700 in special compensation drawn by military doctors.

The president also opposed provisions making bonuses permanent and giving them to dentists, optometrists, pediatricians, and Public Health Service doctors. He said the only serious shortage was among military doctors, not civilian doctors on the federal payroll.

The military physician shortage has been chronic since the end of the doctor draft about seven years ago. That was why Congress approved the bonuses military doctors are now receiving.

[From the New York Times, Sept. 30, 1979]

MEDICAL SCHOOLS FOUND ADMITTING FEWER LOWER-MIDDLE-INCOME STUDENTS

(By Gene I. Maeroff)

Students from families with lower-middle incomes—the children of farmers, craftsmen, sales clerks and others in the \$10,000- to \$20,000-a-year range—are gradually disappearing from the nation's medical schools while the percentage of sons and daughters of physicians and other affluent professionals is increasing.

Surveys of entering classes by the Association of American Medical Colleges show that from 1974 to 1977 the number of students from families in the \$10,000- to \$16,999 group dropped from 20.9 percent to 14.9 percent and those from the \$17,000- to \$20,000 group fell from 13.4 percent to 11.3 percent.

A similar trend is occurring in dental schools throughout the country, according to the American Association of Dental Schools, raising concern among educators in the health professions that students from less wealthy families are possibly being deterred by the high costs from even applying to medical and dental schools.

MEDIAN FAMILY INCOMES COMPARED

"We have been fighting for years to broaden the socio-economic level of entering students, but now we are concerned that medicine is going to return to being a profession for the rich," said John A. D. Cooper, president of the Washington-based association.

Although the national median family income in 1977 was \$16,000, according to the Bureau of the Census, the median for new medical students that year was \$26,000.

Part of the problem is that medical and dental schools are concentrating scholarship aid on the most economically deprived students at the same time that the Government's policy is shifting away from scholarships and toward loans. Affluent students can fall back on family resources, but lower-middle-income students must rely heavily on loans.

Some educators maintain that the high level of debt that such students incur has implications for both where they choose to practice and the specialties they pursue. Under the Government's Health Education Assistance Loan program, a student who borrows \$8,000 for each of the four years of medical school and begins a 15-year repayment program after completing his residency—seven years after he got the first loan—ends up paying back \$148,700 because of accrued interest, according to the medical colleges association. The interest rate is 12 percent and there is a 2 percent carrying charge. The significance of the amount may be diminished by inflation, but the psychological effect is there nonetheless.

"If a student faces a possible debt of, say, \$70,000 the day he walks out of medical school," said Dr. John Rose, the former medical dean at Georgetown University in Washington, where tuition alone has soared to \$13,500 a year, "he will go into practice in a place where he can pay off that debt quickest. And that sure as hell is not going to be as a family practitioner in rural America."

BORROWING TO THE LIMIT

David Ebert, a third-year medical student at Johns Hopkins University in Baltimore, who grew up on a 40-acre farm in central Ohio, is one of those facing a constant financial struggle. He has borrowed to the limit and both of his parents work, producing a combined income of less than \$20,000 a year.

"They have the burden of helping me bridge the gap and they've never complained, but I know they are making sacrifices," said Mr. Ebert, who still has unpaid loans from his undergraduate days at Ohio State University. "It will be a loss if people from my background are squeezed out of medical schools. We have a blue-collar viewpoint that is helpful in empathizing with certain kinds of patients."

Another example of the impact of rising costs was seen recently at Columbia University, where a young Mexican-American had to turn down a coveted acceptance to the medical school to attend a less expensive state-supported school in his home state of Texas. His indebtedness from financing his undergraduate

education through loans was already so high that he could get no further credit.

The difference in cost to students at public and private medical schools is substantial, with total costs averaging \$10,459 at the independent institutions and \$5,012 at the state schools, which charge about an additional \$2,000 to out-of-state students.

FEWER AT PUBLIC COLLEGES

There are signs, however, that despite lower fees the publicly supported schools are also receiving fewer lower-middle-class students.

For instance, Downstate Medical Center in Brooklyn, a branch of the State University of New York, found that a smaller proportion of its entrants are coming from families in which the students' fathers are clerical and sales workers and small businessmen. Meanwhile, the percentage of students whose fathers are professionals and managerial-level employees has risen sharply.

The College of Medicine and Dentistry of New Jersey, which operates the state's three medical schools and one dental school, has the highest tuition, \$5,500, of any of the nation's public schools. Last year, facing further increases, the students persuaded the Legislature that it was in the best interests of the people of New Jersey to cut a projected tuition increase in half.

New York University is a private institution that has resisted the trend and raised the portion of its entering medical school class from the \$10,000 to \$20,000 background, taking special steps to help this group, which has grown from 11.7 percent of the freshman class in 1976 to 20.5 percent this year.

ASSERTION DOUBTED BY SOME

Spokesmen for medical schools generally insist that family income is not a factor in admissions, but some observers express skepticism and suspect that students from lower-middle-income families may sometimes be at a disadvantage.

"They won't admit it publicly or state it in their catalogues, but some medical schools consider financial background because their financial aid resources are so limited," said Robert Boerner, director of student programs for the Association of American Medical Colleges.

"H. L. Mencken once said that medicine was a rich man's sport and I have been comforted in the last decade that that was past history," said Dr. Henry M. Sel-del, associate medical dean at Johns Hopkins. "But I am scared for the future because I don't think we can have a viable system unless we have a strong cadre of physicians from the entire social spectrum."

Mr. GUARINI. Mr. Beebe, do you have a short statement, because if you have an extended statement, will you put it in the record?

Mr. BEEBE. I will ask you if you have any questions. That is my short statement.

Mr. GUARINI. I think not only should these scholarships be excluded, but I would like to see a lot of other scholarships excluded, because I think there is too much of a burden that we have in our country on the educational system.

We discourage education instead of encouraging it.

I wonder how many students are receiving scholarships actually who are subject to Federal future service?

Ms. HUET. I believe there are about 6,000.

Mr. BEEBE. Each year over 1,000 new scholarships are given out.

Mr. GUARINI. On the merits, you have a good claim and I hope the bill will pass. I see it is sponsored by our chairman, Mr. Rostenkowski, which augurs very well for it.

I want to thank you very much for giving us the benefit of your thinking and for the testimony that you presented.

Any additional information you want to put in the record will be put in the record.

Mr. GUARINI. The hearing will adjourn.

[Whereupon, at 1:45 p.m., the hearing was adjourned.]

APPENDIX

The text, staff summary, and written comments received on each bill considered in this hearing follow.

H.R. 6883

[H.R. 6883, 96th Cong., 2d sess.]

A BILL To amend the Internal Revenue Code of 1954 to revise the rules relating to certain installment sales

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) **SHORT TITLE.**—This Act may be cited as the "Installment Sales Revision Act of 1980".

(b) **AMENDMENT OF 1954 CODE.**—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provisions of the Internal Revenue Code of 1954.

"SEC. 2. INSTALLMENT SALES RULES.

(2) **GENERAL RULE.**—Subpart B of part II of subchapter E of chapter 1 is amended by striking out section 453 and inserting in lieu thereof the following new sections:

"SEC. 453. INSTALLMENT METHOD.

"(a) **GENERAL RULE.**—Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.

"(b) **INSTALLMENT SALE DEFINED.**—For purposes of this section—

"(1) **IN GENERAL.**—The term 'installment sale' means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

"(2) **EXCEPTIONS.**—The term 'installment sale' does not include—

"(A) **DEALER DISPOSITION OF PERSONAL PROPERTY.**—A disposition of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan.

"(B) **INVENTORIES OF PERSONAL PROPERTY.**—A disposition of personal property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

"(c) **INSTALLMENT METHOD DEFINED.**—For purposes of this section, the term 'installment method' means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

"(d) **ELECTION OUT.**—

"(1) **IN GENERAL.**—Subsection (a) shall not apply to any disposition if the taxpayer elects to have subsection (a) not apply to such disposition.

"(2) **TIME AND MANNER FOR MAKING ELECTION.**—Except as otherwise provided by regulations, an election under paragraph (1) with respect to a disposition may be made only on or before the due date prescribed by law (including extensions) for filing the taxpayer's return of the tax imposed by this chapter for the taxable year in which the disposition occurs. Such an election shall be made in the manner prescribed by regulations.

"(3) ELECTION REVOCABLE ONLY WITH CONSENT.—An election under paragraph (1) with respect to any disposition may be revoked only with the consent of the Secretary.

"(e) SECOND DISPOSITIONS BY RELATED PERSONS.—

"(1) IN GENERAL.—If—

"(A) any person disposes of property to a related person (hereinafter in this subsection referred to as the 'first disposition'), and

"(B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the 'second disposition'),

then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

"(2) 2-YEAR CUTOFF FOR PROPERTY OTHER THAN MARKETABLE SECURITIES.—

"(A) IN GENERAL.—Except in the case of marketable securities, paragraph (1) shall apply only if the date of the second disposition is not more than 2 years after the date of the first disposition.

"(B) SUBSTANTIAL DIMINISHING OF RISK OF OWNERSHIP.—The running of the 2-year period set forth in subparagraph (A) shall be suspended with respect to any property for any period during which the related person's risk of loss with respect to the property is substantially diminished by—

"(i) the holding of a put with respect to such property (or similar property),

"(ii) the holding by another person of a right to acquire the property, or

"(iii) a short sale or any other transaction.

"(3) LIMITATION ON AMOUNT TREATED AS RECEIVED.—The amount treated for any taxable year as received by the person making the first disposition by reason of paragraph (1) shall not exceed the excess of—

"(A) the lesser of—

"(i) the total amount realized with respect to any second disposition of the property occurring before the close of the taxable year, or

"(ii) the total contract price for the first disposition, over

"(B) the sum of—

"(i) the aggregate amount of payments received with respect to the first disposition before the close of such year, plus

"(ii) the aggregate amount treated as received with respect to the first disposition for prior taxable years by reason of this subsection.

"(4) FAIR MARKET VALUE WHERE DISPOSITION IS NOT SALE OR EXCHANGE.—For purposes of this subsection, if the second disposition is not a sale or exchange, an amount equal to the fair market value of the property disposed of shall be substituted for the amount realized.

"(5) LATER PAYMENTS TREATED AS RECEIPT OF TAX PAID AMOUNTS.—If paragraph (1) applies for any taxable year, payments received in subsequent taxable years by the person making the first disposition shall not be treated as the receipt of payments with respect to the first disposition to the extent such payments do not exceed the amount treated as received by reason of paragraph (1).

"(6) EXCEPTION FOR CERTAIN DISPOSITIONS.—For purposes of this subsection—

"(A) REACQUISITIONS OF STOCK BY ISSUING CORPORATION NOT TREATED AS FIRST DISPOSITIONS.—Any sale or exchange of stock to the issuing corporation shall not be treated as a first disposition.

"(B) INVOLUNTARY CONVERSIONS NOT TREATED AS SECOND DISPOSITIONS.—A compulsory or involuntary conversion (within the meaning of section 1033) and any transfer thereafter shall not be treated as a second disposition if the first disposition occurred before the threat or imminence of the conversion.

"(C) DISPOSITIONS AFTER DEATH.—Any transfer after the earlier of—

"(i) the death of the person making the first disposition, or

"(ii) the death of the person acquiring the property in the first disposition,

and any transfer thereafter shall not be treated as a second disposition.

"(7) EXCEPTION WHERE TAX AVOIDANCE NOT A PRINCIPAL PURPOSE.—This subsection shall not apply to a second disposition (and any transfer thereafter) if it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax.

"(8) EXTENSION OF STATUTE OF LIMITATIONS.—The period for assessing a deficiency with respect to a disposition (to the extent such deficiency is attributable to the application of this subsection) shall not expire before the day which is 2 years after the date on which the person making such disposition furnishes (in such manner as the Secretary may by regulations prescribe) a certificate that there was a second disposition of the property to which this subsection applied. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such assessment.

"(f) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) RELATED PERSON.—The term 'related person' means a person whose stock would be attributed under section 318(a) to the person first disposing of the property.

"(2) MARKETABLE SECURITIES.—The term 'marketable securities' means any security for which, as of the date of the disposition, there was a market on established securities market, or otherwise.

"(3) PAYMENT.—Except as provided in paragraph (4), the term 'payment' does not include the receipt of evidences of indebtedness of the person acquiring the property.

"(4) PURCHASER EVIDENCES OF INDEBTEDNESS PAYABLE ON DEMAND OR READILY TRADABLE.—Receipt of a bond or other evidence of indebtedness which—

"(A) is payable on demand, or

"(B) is issued by a corporation or a government or political subdivision thereof and is readily tradable, shall be treated as receipt of payment.

"(5) READILY TRADABLE DEFINED.—For purposes of paragraph (4), the term 'readily tradable' means a bond or other evidence of indebtedness which is issued—

"(A) with interest coupons attached or in registered form (other than one in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

"(B) in any form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market.

"(6) LIKE-KIND EXCHANGES.—In the case of any exchange described in section 1031(b)—

"(A) the total contract price shall be reduced by the amount of any property permitted to be received in such exchange without recognition of gain,

"(B) the gross profit from such exchange shall be reduced by the amount of gain not recognized by reason of section 1031(b), and

"(C) the term 'payment' does not include any property permitted to be received in such exchange without recognition of gain.

Similar rules shall apply in the case of an exchange which is described in section 356(a) and is not treated as a dividend.

"(g) USE OF INSTALLMENT METHOD BY SHAREHOLDERS IN SECTION 337 LIQUIDATIONS.—

"(1) RECEIPT OF OBLIGATIONS NOT TREATED AS RECEIPT OF PAYMENT.—

"(A) IN GENERAL.—If, in connection with a liquidation to which section 337 applies, in a transaction to which section 331 applies the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period set forth in section 337(a), then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

"(B) OBLIGATIONS ATTRIBUTABLE TO SALE OF INVENTORY MUST RESULT FROM BULK SALE.—Subparagraph (A) shall not apply to an installment obligation described in section 337(b)(1)(B) unless such obligation is also described in section 337(b)(2)(B).

"(C) SALES BY LIQUIDATING SUBSIDIARY.—For purposes of subparagraph (A), in any case to which section 337(c)(3) applies, an obliga-

tion acquired in respect of a sale or exchange by the selling corporation shall be treated as so acquired by the corporation distributing the obligation to the shareholder.

"(2) DISTRIBUTIONS RECEIVED IN MORE THAN 1 TAXABLE YEAR OF SHAREHOLDER.—If—

"(A) paragraph (1) applies with respect to any installment obligation received by a shareholder from a corporation, and

"(B) by reason of the liquidation such shareholder receives property in more than 1 taxable year,

then, on completion of the liquidation, basis previously allocated to property so received shall be reallocated for all such taxable years so that the shareholder's basis in the stock of the corporation is properly allocated among all property received by such shareholders in such liquidation.

"(h) REGULATIONS.—

"(1) IN GENERAL.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section.

"(2) SELLING PRICE NOT READILY ASCERTAINABLE.—The regulations prescribed under paragraph (1) shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

"SEC. 453A. INSTALLMENT METHOD FOR DEALERS IN PERSONAL PROPERTY.

"(a) GENERAL RULE.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

"(2) TOTAL CONTRACT PRICE.—For purposes of paragraph (1), the total contract price of all sales of personal property on the installment plan includes the amount of carrying charges or interest which is determined with respect to such sales and is added on the books of account of the seller to the established cash selling price of such property. This paragraph shall not apply with respect to sales of personal property under a revolving credit type plan.

"(b) CHANGE FROM ACCRUAL TO INSTALLMENT BASIS.—

"(1) GENERAL RULE.—If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his taxable income on the installment basis, then in computing his taxable income for such year (referred to in this subsection as 'year of change') or for any subsequent year—

"(A) installment payments actually received during any such year on account of sales or other dispositions of property made in any taxable year before the year of change shall not be excluded; but

"(B) the tax imposed by this chapter for any taxable year (referred to in this subsection as 'adjustment year') beginning after December 31, 1953, shall be reduced by the adjustment computed under paragraph (2).

"(3) ADJUSTMENT IN TAX FOR AMOUNTS PREVIOUSLY TAXED.—In determining the adjustment referred to in paragraph (1)(B), first determine, for each taxable year before the year of change, the amount which equals the lesser of—

"(A) the portion of the tax for such prior taxable year which is attributable to the gross profit which was included in gross income for such prior taxable year, and which by reason of paragraph (1)(A) is includible in gross income for the taxable year, or

"(B) the portion of the tax for the adjustment year which is attributable to the gross profit described in subparagraph (A).

The adjustment referred to in paragraph (1)(B) for the adjustment year is the sum of the amounts determined under the preceding sentence.

"(3) RULE FOR APPLYING PARAGRAPH (2).—For purposes of paragraph (2), the portion of the tax for a prior taxable year, or for the adjustment year, which is attributable to the gross profit described in such paragraph is that amount which bears the same ratio to the tax imposed by this chapter,

other than by sections 55 and 56 for such taxable year (computed without regard to paragraph (2)) as the gross profit described in such paragraph bears to the gross income for such taxable year.

"(4) **REVOCATION OF ELECTION.**—An election under paragraph (1) to report taxable income on the installment basis may be revoked by filing a notice of revocation, in such manner as the Secretary prescribes by regulations, at any time before the expiration of 3 years following the date of the filing of the tax return for the year of change. If such notice of revocation is timely filed—

"(A) the provisions of paragraph (1) and subsection (a) shall not apply to the year of change or for any subsequent year;

"(B) the statutory period for the assessment of any deficiency for any taxable year ending before the filing of such notice, which is attributable to the revocation of the election to use the installment basis, shall not expire before the expiration of 2 years from the date of the filing of such notice, and such deficiency may be assessed before the expiration of such 2-year period notwithstanding the provisions of any law or rule of law which would otherwise prevent such assessment; and

"(C) if refund or credit of any overpayment, resulting from the revocation of the election to use the installment basis, for any taxable year ending before the date of the filing of the notice of revocation is prevented on the date of such filing, or within one year from such date, by the operation of any law or rule of law (other than section 7121 or 7122), refund or credit of such overpayment may nevertheless be made or allowed if claim therefor is filed within one year from such date. No interest shall be allowed on the refund or credit of such overpayment for any period prior to the date of the filing of the notice of revocation.

"(5) **ELECTION AFTER REVOCATION.**—If the taxpayer revokes under paragraph (4) an election under paragraph (1) to report taxable income on the installment basis, no election under paragraph (1) may be made, except with the consent of the Secretary, for any subsequent taxable year before the fifth taxable year following the year of change with respect to which such revocation is made.

"(c) **CARRYING CHARGES NOT INCLUDED IN TOTAL CONTRACT PRICE.**—If the carrying charges or interest with respect to sales of personal property, the income from which is returned under subsection (a)(1), is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest.

"SEC. 453B. GAIN OR LOSS ON DISPOSITION OF INSTALLMENT OBLIGATIONS.

"(a) **GENERAL RULE.**—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and—

"(1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or

"(2) the fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange.

Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

"(b) **BASIS OF OBLIGATION.**—The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

"(c) **SPECIAL RULE FOR TRANSMISSION AT DEATH.**—Except as provided in section 691 (relating to recipients of income in respect of decedents), this section shall not apply to the transmission of installment obligations at death.

"(d) **EFFECT OF DISTRIBUTION IN CERTAIN LIQUIDATIONS.**—

"(1) **LIQUIDATIONS TO WHICH SECTION 332 APPLIES.**—If—

"(A) an installment obligation is distributed in a liquidation to which section 332 (relating to complete liquidations of subsidiaries) applies, and

"(B) the basis of such obligation in the hands of the distributee is determined under section 334(b)(1), then no gain or loss with respect to the distribution of such obligation shall be recognized by the distributing corporation.

"(2) LIQUIDATIONS TO WHICH SECTION 337 APPLIES.—If—

"(A) an installment obligation is distributed by a corporation in the course of a liquidation, and

"(B) under section 337 (relating to gain or loss on sales or exchanges in connection with certain liquidations) no gain or loss would have been recognized to the corporation if the corporation had sold or exchanged such installment obligation on the day of such distribution, then no gain or loss shall be recognized to such corporation by reason of such distribution. The preceding sentence shall not apply to the extent that under paragraph (1) gain to the distributing corporation would be considered as gain to which section 341(f), 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a) applies.

"(e) LIFE INSURANCE COMPANIES.—In the case of a disposition of an installment obligation by any person other than a life insurance company (as defined in section 801(a)) to such an insurance company or to a partnership of which such an insurance company is a partner, no provision of this subtitle providing for the nonrecognition of gain shall apply with respect to any gain resulting under subsection (a). If a corporation which is a life insurance company for the taxable year was (for the preceding taxable year) a corporation which was not a life insurance company, such corporation shall, for purposes of this subsection and subsection (a), be treated as having transferred to a life insurance company, on the last day of the preceding taxable year, all installment obligations which it held on such last day. A partnership of which a life insurance company becomes a partner shall, for purposes of this subsection and subsection (a), be treated as having transferred to a life insurance company, on the last day of the preceding taxable year of such partnership, all installment obligations which it holds at the time such insurance company becomes a partner.

"(f) OBLIGATION BECOMES UNENFORCEABLE.—For purposes of this section, if any installment obligation is cancelled or otherwise becomes unenforceable—

"(1) the obligation shall be treated as if it were disposed of in a transaction other than a sale or exchange, and

"(2) if the obligor and obligee are related persons (within the meaning of section 453(f)(1)), the fair market value of the obligation shall be treated as not less than its face amount."

(h) TECHNICAL AMENDMENTS.—

(1) Sections 311(a), 336, and 691(a)(4) are each amended by striking out "section 453(d)" each place it appears and inserting in lieu thereof "section 453B".

(2) Subsection (d) of section 481 is amended by striking out "section 453" and inserting in lieu thereof "section 453A".

(3) Subsection (f) of section 644 is amended by striking out "elects to report income under section 453" and inserting in lieu thereof "reports income under section 453".

(c) CLERICAL AMENDMENT.—The table of sections for such subpart B is amended by striking out the item relating to section 453 and inserting in lieu thereof the following:

"Sec. 453. Installment method.

"Sec. 453A. Installment method for dealers in personal property.

"Sec. 453B. Gain or loss on disposition of installment obligations."

SEC. 3. COORDINATION WITH SECTION 691.

The second sentence of section 691(a)(2) of the Internal Revenue Code of 1954 (relating to income in respect of decedents) is amended by inserting "(other than the obligor)" after "or a transfer to a person".

SEC. 4. AMENDMENT OF SECTION 1038.

Section 1038 (relating to certain reacquisitions of real property) is amended by adding at the end thereof the following new subsection:

"(g) ACQUISITION BY ESTATE, ETC., OF SELLER.—Under regulations prescribed by the Secretary, if an installment obligation is indebtedness to the seller which is described in subsection (a), and if such obligation is, in the hands of the taxpayer, an obligation with respect to which section 691(a)(4)(B) applies, then—

"(1) for purposes of subsection (a), acquisition of real property by the taxpayer shall be treated as reacquisition by the seller, and

"(2) the basis of the real property acquired by the taxpayer shall be increased by an amount equal to the deduction under section 691(c) which would (but for this subsection) have been allowable to the taxpayer with respect to the gain on the exchange of the obligation for the real property."

SEC. 5. EFFECTIVE DATES.

(a) FOR SECTION 2.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by section 2 shall apply to dispositions made after the date of the enactment of this Act in taxable years ending after such date.

(2) FOR SECTION 453(e).—Section 453(e) of the Internal Revenue Code of 1954 (as amended by section 2) shall apply to dispositions made after March 31, 1980.

(3) FOR SECTION 453(g).—Section 453(g) of such Code (as amended by section 2) shall apply to plans of liquidation adopted after the date of the enactment of this Act.

(4) FOR SECTION 453B(f).—Section 453B(f) of the Internal Revenue Code of 1954 (as amended by section 2) shall apply to installment obligations becoming unenforceable after the date of the enactment of this Act.

(b) FOR SECTION 3.—The amendment made by section 3 shall apply in the case of decedents dying after the date of the enactment of this Act.

(c) FOR SECTION 4.—The amendment made by section 4 shall apply to acquisitions of real property after the date of the enactment of this Act.

BRIEF SUMMARY—H.R. 6883

H.R. 6883 would amend the rules for reporting gains under the installment method for sales of real property and casual sales of personal property.

Specifically the bill would make the following changes:

(1) *Structural improvements.*—Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the basic rules for nondealer transactions would be contained in one Code section (sec. 453), the rules for dealer transactions would be contained in another section (sec. 453A), and generally applicable installment obligation disposition rules would be contained in a third section (sec. 453B).

(2) *Initial payment limitation.*—The bill would eliminate the requirement that no more than 30 percent of the selling price be received in the taxable year of sale to qualify for installment sale reporting for gains from sales of realty and nondealer personal property.

(3) *Two-payment rule.*—The bill would eliminate the requirement that a deferred payment sale be for two or more payments. Thus, a sale will be eligible for installment reporting even if the purchase price is to be paid in a single lump-sum amount in a year subsequent to the taxable year in which the sale is made.

(4) *Selling price requirements.*—The bill would eliminate the requirement that the selling price for casual sales of personal property must exceed \$1,000 to qualify for installment sale reporting.

(5) *Election.*—The bill would eliminate the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, the provision would automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale.

(6) *Related party sales.*—The bill would prescribe special rules for situations where there is an installment sale to a related party who also disposes of the property.

Under the bill, the amount realized upon a resale by the related party installment purchaser would trigger recognition of gain by the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale would generally result only to the extent additional cash and other property flows into the related group as a result of a second disposition of the property.

The excess of any amount realized from resales over payments received on the first sale as of the end of a taxable year would be taken into account. Thus, the tax treatment would not turn on the strict chronological order of when resales or payments are made. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller would be recovered tax-free until they equaled the amount realized from the resale which resulted in the acceleration of recognition of gain.

In the case of property other than marketable stock and securities, the resale rule would apply only with respect to second dispositions occurring within 2 years of the initial installment sale. In the case of marketable stock and securities, the resale rule would apply without a time limit for resales occurring before the installment obligation is satisfied.

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is nontaxable and therefore its basis in the stock is irrelevant, the related party rule will not apply to any sale or exchange of stock to the issuing corporation. In addition, there generally would be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property or which occurs after the death of the installment seller or purchaser. Finally, the resale rules would not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters. However, it is to be understood that the omission of a specific family relationship is not intended to preclude the Internal Revenue Service from asserting the proper tax treatment to transactions that are shams.

(7) *Like-kind exchanges.*—The bill would provide that the receipt of like-kind property in connection with a disposition will not be taken into account in determining gain recognized for installment sale reporting purposes. Under the present Internal Revenue Service position, the receipt of like-kind property results in the recognition of installment gain before cash is received by the taxpayer because the value of such property is treated as a payment received. The bill would reverse this rule.

(8) *Installment obligations distributed in a corporate liquidation.*—The bill would provide nonrecognition of gain treatment for a shareholder who receives installment obligations as liquidating distributions from a corporation liquidating within 12 months of adoption of a plan of liquidation. In general, this rule would apply to obligations arising from sales by the corporation during the 12-month period. Obligations from the sale of inventory would qualify only if the inventory of that trade or business is sold in bulk. The gain realized by the shareholder on his stock would be recognized as payments are received on the installment obligation. Thus, in most significant aspects, the tax consequences to a shareholder would be essentially the same whether the corporation sells its assets and then distributes installment obligations in liquidation or the shareholder makes an installment sale of the stock.

(9) *Sales subject to a contingency.*—The bill would permit installment sale reporting for sales for a contingent selling price. Under present law, these sales are not eligible for installment reporting. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transaction. Rather, the bill provides that the specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. In cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that the basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type period.

(10) *Cancellation of installment obligation.*—The bill would make it clear that the cancellation of an installment obligation other than by death is treated as a disposition of the obligation by the holder of the obligation.

(11) *Request of obligation to obligor.*—The bill would provide that the installment obligation disposition rules cannot be avoided by requesting an obligation to the obligor.

(12) *Foreclosure of real property sold on installment method by deceased taxpayer.*—The bill would provide that an executor or beneficiary who receives a secured installment obligation from a decedent will succeed the decedent for purposes of qualifying for nonrecognition treatment if the real property sold is reacquired in cancellation of the obligation.

(13) *Effective dates.*—In general, the bill would be effective for sales, cancellations, bequests, and reacquisition of real property, as the case may be, occurring after the date of enactment. However, the related party installment sale rules would apply to installment sales after March 31, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation would apply with respect to plans of liquidation adopted after the date of enactment.

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., April 25, 1980.

HON. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the American Bankers Association, which consists of over 90 percent of the nation's 14,000 full service banks, I would like to comment on two tax bills on which your Committee took testimony on April 17, 1980.

H.R. 6883, Installment Sales Revenue Act of 1980

In our earlier testimony on H.R. 3899 before the Ways and Means Committee on July 13, 1979, the American Bankers Association indicated its objections to the provision in the bill concerning the disallowance of reporting sales on an installment basis where the sale was made to a related party. This disallowance applied whether or not the property was subject to a subsequent sale. The proposal failed to recognize legitimate family transactions.

The bill presently under consideration by the Ways and Means Committee, H.R. 6883, contains a provision which would permit installment method reporting for sales between related parties. This new proposal recognizes the applicability of installment sales treatment to legitimate family transactions, and the ABA believes this revised proposal is a significant improvement. We are pleased to offer our support for its enactment.

H.R. 5729, to provide for the amortization of start-up expenditures paid or incurred in starting a new trade or business

The ABA generally supports this bill, which will allow a taxpayer an election to amortize over a period of not less than sixty months ordinary and necessary start-up costs incurred incident to the investigation, formation or creation of a trade or business. This bill would help promote the establishment and potential survival of new businesses. It also provides, in some measure, equal treatment with pre-opening expenses of existing businesses.

However, we oppose the suggestions of the Treasury Department, as made by Daniel Halperin, Deputy Assistant Secretary for Tax Legislation, that the bill be clarified to require that the election must be made not later than the time prescribed for filing the return for the year the expense was paid. In his testimony on April 17 he expressed the hope that enactment of this bill would induce taxpayers with existing businesses to elect to amortize start-up marginally related businesses, thereby reducing a number of controversies in this area. In effect, taxpayers would be required to elect to amortize pre-opening expenses of related businesses, rather than to currently deduct them and risk their disallowance, if the IRS maintains that such costs must be capitalized as a result of subsequent examination.

While the concern of the Treasury to reduce the number of present controversies is understandable, taxpayers reasonably believing that such costs relate to an existing trade or business (such as geographic extension of a present business) should not be required to forego a current deduction. As envisioned by the Treasury this provision, instead of providing an election to allow the

amortization of a number of previously nondeductible expenses, will serve to require the deferral over sixty months of a substantial number of presently deductible expenses.

We believe that with the enactment of this bill the number of controversies is likely to be reduced since a large number of taxpayers seeking certainty for tax planning purposes are likely to exercise the election. Also, the number of litigated cases is likely to be minimized since many taxpayers would choose to exercise the election if the IRS proposes to disallow a current deduction. Accordingly, we would urge that the bill be amended to provide that the election be made at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax for the taxable year the expense was paid.

We would also suggest that the bill (or the committee report) clarify that if a taxpayer omits certain items from the election which are later treated as start-up expenses by an examining agent, these amount also qualify for amortization. If a taxpayer is placed at risk in identifying start-up expenditures, an unnecessary number of controversies will continue.

Thank you for the opportunity to comment on these bills.

Very truly yours,

ROBERT L. BEVAN,
Senior Government Relations Counsel.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

This statement is submitted by the American Council of Life Insurance, a trade association representing 504 life insurance companies which, in the aggregate, account for approximately 95 percent of the life insurance in force in the United States and hold 97 percent of the assets of all United States life insurance companies.

We are pleased to have this opportunity to comment in connection with the public hearings on H.R. 6883, a bill to revise installment sales taxation, and several other tax bills. In particular, we urge that a provision be added to H.R. 6883 to provide for the repeal or revision of section 453(d)(5) of the Internal Revenue Code which deals with the tax treatment of transfers of installment obligations to life insurance companies. In this regard, the Ways and Means Committee tentatively adopted a revision of this provision in connection with the development of the Revenue Act of 1974. We also support enactment of H.R. 6824, which would clarify the rules for taxing unfunded deferred compensation arrangements of employees of tax-exempt organizations.

SPECIFIC COMMENTS

Revision of installment sales taxation—tax treatment of transfers of installment obligations to life insurance companies.—Section 453(d)(5) of the Internal Revenue Code generally provides that, notwithstanding other provisions of the Code, gain must be recognized on the transfer of an installment obligation to a life insurance company (or to a partnership of which a life insurance company is a partner). For the reasons given below, we urge that section 453(d)(5) of the Code be repealed as part of the revisions of the installment sales provisions included in H.R. 6883.

Section 453(d)(5) was enacted by the Technical amendments Act of 1958 (Public Law 85-806) in order to meet a particular problem arising under the tax provisions then applicable to life insurance companies. At that time, which was prior to the enactment of the Life Insurance Company Income Tax Act of 1959, life insurance companies were taxed only on their investment income. Thus, the following situation could have arisen with respect to the transfer of installment obligations to a life insurance company. If the transfer was in connection with a tax-free transaction (for example, a transaction described in section 351), no gain was recognized by the transferor. Moreover, the gain, when subsequently realized by the life insurance company, was not subject to tax since it was not an item of investment income. The purpose of section 453(d)(5) was to tax the transferor of the installment obligation in this situation by providing that the nonrecognition of gain provisions did not apply in the case of such a transfer.

The Life Insurance Company Income Tax Act of 1959 significantly changed the tax treatment of life insurance companies by expanding their tax base to a total income computation. Thus, the basic reason for section 453(d)(5) no longer exists since any gain realized on an installment obligation transferred to a life insurance company is now an item of income which must be included in the company's tax calculation. For this reason, we believe it appropriate to repeal section 453(d)(5).

If it is determined, however, that complete repeal of section 453(d)(5) is not appropriate, we urge that the Subcommittee adopt the approach that was taken by the full Ways and Means Committee during the development of the tax reform bill in 1974. Under such an approach, section 453(d)(5) would not apply where the insurance company elects to include installment income in gross investment income. (Section 223 of Ways and Means Committee Print No. 2, Tentative Draft of Title II, Changes Primarily Affecting Corporations.)

Treatment of unfunded deferred compensation arrangements for employees of tax-exempt organization.—A question has been raised as to the tax treatment of unfunded deferred compensation arrangements of tax-exempt organizations by the Revenue Act of 1978. As you know, the Act contains two provisions which preempt an IRS proposed regulation¹ as it relates to unfunded deferred compensation arrangements maintained by State and local governments and private taxable entities. However, the Act does not deal with the status of such plans established by tax-exempt organizations, although the Senate version would have accorded them the same tax treatment given to taxable entities. Thus, the IRS has proposed to apply the above-cited regulation, when finalized, to such arrangements. We have argued strongly to the IRS that such a move would be contrary to existing law, and we believe that, eventually, we would be sustained by the courts. However, to avoid such confusion and lengthy litigation, we support efforts, such as H.R. 6824, to codify this position in the law.

Unfunded deferred compensation plans in the tax-exempt sector are employed in the same manner as in the private sector. Within both sectors, deferred compensation is relied upon by a wide variety of enterprises to secure the services of the best possible people and are designed to meet the unique financial needs of both the employee (or independent contractor) and the employer. To treat taxable entities and tax-exempt organizations differently with respect to the tax rules of unfunded deferred compensation plans would impair the ability of tax-exempt organizations to effectively compete with private industry for key personnel.

Therefore, we support the enactment of H.R. 6824, which would make clear that unfunded deferred compensation arrangements for employees of tax-exempt organizations are treated under the same tax rules as arrangements of private taxable employers.

We appreciate having the opportunity to present our views. We would be happy to attempt to furnish any additional information which the Subcommittee might think helpful.

AMERICAN FARM BUREAU FEDERATION,
Washington, D.C., April 25, 1980.

HON. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The subcommittee recently held a day of hearings on miscellaneous tax bills, including H.R. 6883. This bill revises the reporting rules for gains from installment sales under Section 453 of the Internal Revenue Code.

Farm Bureau testified last summer before the Subcommittee on a similar bill, H.R. 3899. In an effort to discourage abuse of the installment sales method, H.R. 3899 included a provision to prohibit the use of installment sales between related parties. Farm Bureau opposed this restriction because the installment sales method is widely used by farm families in the transfer of farm properties from one generation of a family to the next.

¹ Under the proposed IRS regulation, an employee who has the option to receive salary currently, but elects to have it deferred, would be taxed at the time the amount would have been paid if deferral had not been elected.

H.R. 6883 is a preferable bill because it allows sales between related parties subject to a restriction on re-sale of the property within two years. It also accommodates sales as a result of involuntary conversions.

Thank you for consideration of our comments, and we ask that they be inserted in the hearing record.

Sincerely,

VERNIE GLASSON,
Director, National Affairs Division.

STATEMENT OF ROBERT V. CRITES, BOSTON, MASS.

I oppose the provisions of the above-captioned bill which would eliminate related party sales where a family trust is established. My opposition is based on major economic and public policy reasons as set forth below.

I constantly see the situation where a U.S. citizen has held an asset which he purchased, inherited or earned such as securities, a family business or a farm for a number of years. The value of such asset through inflation, good management and/or market demand has appreciated from say \$100,000 to \$300,000. The individual owns this asset—it is his. If he sells it there will be a tax and he is willing to pay the tax but often only if he can spread the tax out over a period of years using installment sale reporting. When he is given the option of selling the asset to a second party buyer and taking back a promissory note (where real estate is involved) or selling a small position in his stock to the stock market each year over say a five year period (where securities are involved) or selling the asset to an irrevocable family trust the individual will often opt to sell to a trust because he wants the trust beneficiaries who are his children to receive financial benefits from the trust during and after the term of the trust.

My main points:

1. No income tax avoidance is attempted or accomplished where a trust is the buyer. A sale has been made and the income taxes will be paid.

2. Capital is freed up by encouraging the sale of an asset rather than having the individual hold the asset and wait for death in order to get a step up in cost basis for his heirs.

3. The Treasury will receive more money in tax dollars since more sales will be done using this method of installment sale reporting and now we have an additional income taxpayer—the Trustee—in addition to the individual as a taxpayer.

4. The entire family unit benefits by having more capital at work within the family trust! Is this bad? Why should we have to knock out ways to help the family do income and estate tax planning?

The reasons for creating an irrevocable trust in addition to having it be an entity able to purchase and/or sell an asset are:

1. To pay income and/or principal to the income beneficiaries according to their needs—food, clothing, education, etc. These provisions are spelled out within the trust agreement.

2. To provide professional money management for the family.

3. To create an entity which can receive annual tax free gifts from various donors.

4. To provide for various personal and financial needs and protections for the trust beneficiaries.

Any installment sale done to an irrevocable trust is evidenced by an installment note and installment sales contract bearing at least 6 percent interest (re the section 483 rules) and is fully enforceable by the seller, his creditors, fiduciaries, etc. in an action against the Trustee.

Using a total return concept of securities investing, a prudent Trustee has historically been able to pay off the principal and interest of the installment obligation while having assets remaining within the trust after the payments on the installment note have been completed. The Trustee purchasing the asset from the individual would often sell such asset (or part of it) in order to diversify. Is this bad? I keep hearing that capital movement and new capital formation and capital stimulation by the private sector are finally finding new recognition in Washington. This is a great by-product of these types of trusts along with an in-

crease in taxable revenue by those few individuals who have now found an acceptable way to sell their appreciated asset.

I believe the only possible objectionable areas in the use of installment sale reporting where a trust is used is with a prearranged Section 337 situation (such as Rushing may have been) or possibly with a same day transaction (where the trust creation, sale to the trust, sale by the trust are all done on the same day). A two year holding rule as per the section 644 area I believe is totally without use or merit—let the Trustee sell when it is deemed most prudent and not be bound up by these various "tax restricted" holding periods which just serve to tie up capital and possibly encourage lawsuits against fiduciaries.

I hope you will allow the parts of H.R. 6883, Installment Sales Revision Act of 1980, relating to the sale of appreciated assets to a family trust to die. Thank you for your review of this subject.

STATEMENT OF SANFORD M. GUERIN, PROFESSOR OF LAW, UNIVERSITY OF DENVER
SCHOOL OF LAW

INTRODUCTION

In an era characterized by rapidly appreciating real estate, rising interest rates, and an inflationary economy, an investor may wish to cash out a substantial real estate investment to obtain greater liquidity while still remaining in the real estate market as a hedge against inflation. An investor may utilize three basic methods to dispose of appreciated property while partially or totally reinvesting in new property: a section 1031 tax-free exchange, a straight sale followed by reinvestment, and a section 453 installment sale followed by reinvestment. As this article will illustrate, a fourth method, the hybrid 1031/453 transaction, may be the most effective tax planning tool in situations where an investor wishes to trade-down his net real estate holdings.

A typical "tax-planned" S1031 exchange involves a trading up by an investor of low value, low basis property for more heavily encumbered, high value property. In addition to the increased leverage obtained, the investor's motive for such an exchange is the acquisition of a higher depreciable basis, increased in part by the assumption of the liability to which the acquired property is subject.¹ However, since trading up under S1031 will ordinarily not involve a cashing out by the investor of his investment, the desire for liquidity will not be met.²

If, however, an investor wishes to completely liquidate his investment, then a straight sale may be the best method available. The straight sale of property for cash, followed by reinvestment of the proceeds, would result in full gain recognition upon disposition of the old property under S1001 principles, and a fair market value cost basis in the reinvestment property pursuant to S1012.³

¹ Section 1031(d) specifies the formula for determining the basis of property received in a like kind exchange: Basis of property exchanged plus gain recognized minus money received minus loss recognized. Treas. Reg. § 1.1031(b)-1(c), and Treas. Reg. § 1.1031(d)-2, ex. 2, provide for the offsetting of liabilities on the exchanged properties. The taxpayer in the Regulation's example transferred property subject to an \$80,000 liability, but received in exchange property subject to a \$150,000 liability. As a result of taking property subject to a greater encumbrance the taxpayer was deemed not to receive "boot" with respect to the \$80,000 of debt relief. (It should be observed that the receipt of \$40,000 cash by the taxpayer in that situation did constitute "boot," the negative mortgage balance of the taxpayer not offsetting money or other unlike-kind property received.) The basis of the property received by the taxpayer was increased by the taxpayer's negative mortgage balance. In reaching this result, the liability on the property received was first added to the basis of the transferred property (considered as other property transferred under Treas. Reg. § 1.1031(d)-1(a)), and then the liability on the property transferred was subtracted from the resulting sum (considered as money received for purposes of this computation, I.R.C. § 1031(d)).

² If, however, the taxpayer refinanced his property prior to the exchange, he could cash out to that extent, possibly without gain recognition. *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952). Such a transaction, though, may be subject to attack by the Service under the step transaction or business purposes doctrine.

³ Immediate gain recognition may be avoided if the sale is designed as a deferred payment sale qualifying for open transaction reporting. *Burnet v. Logan*, 283 U.S. 404 (1931). In such a situation, a taxpayer need not report any gain as payments are received from the purchaser until the aggregate payments exceed the taxpayer's adjusted basis in the old property. Each payment, or portion thereof, received after the taxpayer has recovered his basis must be reported in full as gain. In an open transaction, a taxpayer could reinvest in another property after payments have been received which are sufficient to complete the new purchase. The basis in the new property would then be a fair market value cost basis under § 1012.

Between these extremes lie two other tax planning alternatives. The first is the installment method of reporting gain under §453(b),⁴ which while requiring full gain recognition, still permits a taxpayer to spread the reporting of this gain ratably over the term of the payments actually received upon the installment obligations. The taxpayer can then reinvest in other property at any time, although the cash received upon the installment obligations will have been taxed. The basis of any newly-acquired property would be a fair market value cost basis under §1012.

The final available alternative is the hybrid 1031/453 transaction. This generally involves the reverse situation of the typical "tax-planned" §1031 exchange—the trading down by the taxpayer of high value property for low value property, accompanied by the receipt of "other property," cash, or notes. The "boot" received in the hybrid 1031/453 transaction will include the cash, "other property," and the purchaser-exchange's notes representing partial or full payment for the value differential of the properties. This type of transaction is basically a substitute for installment method reporting, with one important variation: in the hybrid 1031/453 transaction, the reinvestment property must qualify as like kind property⁵ and is considered a payment in the year of sale (PYOS) for purposes of the thirty percent test of §453(b)(2)(B). Thus, the reinvestment is integrated with the sale of the old property into a single plan, with the taxpayer perhaps selecting the reinvestment property, the purchaser acquiring the selected property, and then exchanging it with the taxpayer for the old property.⁶

A taxpayer in a 1031/453 hybrid transaction will ordinarily receive the purchaser-exchange's notes (considered "boot" for purposes of §1031), which he may elect to report on the installment method assuming the requirements of §453 are met.⁷ For a taxpayer who can qualify this transaction under both §1031 and §453, there are then two advantages to the hybrid 1031/453 transaction over conventional installment reporting. First, due to the application of §1031, the realized gain will not be fully recognized if the value of the like kind reinvestment property exceeds the adjusted basis of the old property—the gain will only be reported to the extent of the "boot." This reduced gain recognition will be effected by applying a smaller profit reporting ratio (PRR) to

⁴ Gain from the sale or other disposition of real property, or from the casual sale or other disposition of non-inventory personal property for a price greater than \$1000, may be reported on the installment method under Section 453(b). Under the installment method, the taxable portion of each installment payment is equal to:

(Gross profit/total contract price) X (Installment payment) = amount to be reported as gain in the year received. See "Principles of §453," *infra*.

⁵ Like-kind property is defined as property of the same nature or character as the transferred property, and not as property of the same quality or grade. Thus, improved realty and unimproved realty are like-kind properties (Treas. Reg. §1.1031(a)-1(b)); urban realty and a ranch are like-kind properties (Treas. Reg. §1.1031(a)-1(c)); a fee interest in realty and a 30 year leasehold interest in realty are like-kind properties (Treas. Reg. §1.1031(a)-1(c)(19)); a fee interest in realty and a mineral interest in realty are like-kind properties. *Commissioner v. Crichton*, 122 F. 2d 181 (5th Cir. 1941).

Like-kind property must be held by the taxpayer for productive use in a trade or business, or for investment, to be within the provisions of §1031(a). Further, §1031(a) specifically excludes inventory, stocks, bonds, and similar interests from its definition of like-kind properties entitled to the non-recognition treatment of the section.

⁶ The taxpayer, in order to obtain the benefits of §1031, must avoid making the purchaser his agent in the transaction. The typical §1031 exchange will invoke selection by the taxpayer of the property he wishes to receive, the arrangement by the taxpayer of the terms of purchase of such property by his exchange partner, the purchase of such property by the individual who wants the taxpayer's property, and the exchange of properties by the taxpayer and such purchaser. If the purchaser-exchange is deemed to be the taxpayer's agent in the transaction, the transaction will be restructured into the form of an outright sale by the taxpayer of his property to the purchaser, followed by a straight purchase by the taxpayer of the property selected by him. See *Alderson v. Commissioner*, 317 F. 2d 790, 63-2 USTC ¶9499 (9th Cir. 1963), where the service advanced such an argument. Such an interpretation of the transaction of course negates the exchange requirement of §1031.

The courts have been reluctant to find the purchaser to be the taxpayer's agent in the typical like-kind exchange, reasoning that the purchaser is at risk since the transfer of the selected property to the taxpayer is not strictly guaranteed (*Alderson*, *supra*). The Service seems to have accepted this theory in Revised Ruling 77-297, 1977-2 CB 304, citing *Alderson* *supra*, favorably, while in addition emphasizing that the purchaser was not the taxpayer's agent since the seller of the selected property to the purchaser could not look to the taxpayer for specific performance upon default.

The court in *Alderson*, *supra*, and the Service in Revised Ruling 77-297, *supra*, have not regarded the taxpayer's agency for the purchaser (e.g., in selecting the property) as vitiating the application of §1031 to the transaction.

⁷ See "Principles of §453," *infra*. The payments received in the year of sale (PYOS) cannot exceed 30 percent of the selling price. I.R.C. §453(b)(2)(B).

each payment under S453.⁸ Secondly, the reinvestment is accomplished with tax-free dollars, again due to S1031.

However, there is one disadvantage to the partial non-recognition achieved in the hybrid 1031/453 transaction. As with all non-recognition provisions, the basis of the reinvestment property will reflect the non-recognized gain, and will be less than the fair market value of the property to the extent of the non-recognized gain.

The following discussion first sets forth the basic principles of S 1031 and 453. Then the interaction of these code sections will be analyzed, with special attention given to the Services analysis of the hybrid 1031/453 transaction in Revenue Ruling 65-155. The Tax Court analysis of the hybrid 1031/453 transaction is found in the case of *Clinton H. Mitchell*, and analysis of this case in conjunction with Revenue Ruling 65-155 will illustrate the inherent problems contained in both. More specifically the effect of the PRR upon the like-kind property received under S1031, the computation of PYOS in such transactions, and the correct basis allocation formulas to be applied to the like-kind property received and the buyer's notes received will be considered. Suggested alternatives to the approach of the Service in Rev. Ruling 65-155 will be discussed, and then applied in the context of multi-party exchanges.

I. PRINCIPLES OF S 1031

Designed as a tax relief measure, S 1031 has received widespread acceptance in recent years in the area of real estate investments. The provision is a nonrecognition section, designed to provide relief when investment property is exchanged for property of a "like kind."

Basic to the use of S 1031 are the requirements that the exchanged properties be (1) of "like kind,"⁹ and (2) held for productive use in the Taxpayer's trade or business or held for investment.¹⁰ The discussion that follows will not address these requisites, but instead, assumes that they have been satisfied. Section 1031 is based on the notion that a taxpayer who does not "cash in" on his investment but merely changes its form may not receive cash or other assets of sufficient liquidity to enable him to satisfy the tax liability if the transaction under tax law were to require recognition of gain.¹¹ This is not to say that the taxpayer doesn't realize gain; he does, but doesn't, with the exception of "boot," recognize gain at that time. Instead, the gain realized but not recognized will be reflected in the taxpayer's basis adjustments pursuant to S1031(d) in the property which he receives.

Although complying with S1031 appears relatively simple, complications surface where non-like kind property, or boot, is received in addition to the like-kind property. Such a transaction is the rule rather than the exception, since few, if any, real estate transactions will involve properties of identical value with identical liabilities. Indeed, there would seem to be little reason to undertake such a transaction unless the taxpayer merely wanted a different property for purely non-tax, business reasons.

Consequently, the receipt of non-like property brings the transaction under a special provision of S 1031.¹² Nonrecognition of gain is still available, but only as to the like-kind property received in the exchange. "Boot" received in the form of non-like-kind property does not qualify for nonrecognition; thus, gain must be recognized to the extent of "boot" received.

⁸ See discussion of "Revenue Ruling 65-55," § 453 PRR is altered to take account of gain recognized, not the gross profit.

⁹ See note 3.

¹⁰ This is a factual question of intent which is determined by reference to the actions of the taxpayer with respect to the property. Thus, the purchaser in the typical like-kind exchange described in note 3, *supra*, is not deemed to hold the property acquired for productive use in a trade or business or for investment, since he acquired the property for immediate exchange. Revised Ruling 77-287, *supra*.

¹¹ See Trans. Reg. § 1.1002-1(c): "The underlying assumption [of § 1031] is that the new property is substantially a continuation of the old investment still unliquidated . . ."

¹² Section 1031(b): "If an exchange would be within the provisions of subsection (a) . . . if it were not for the fact that the property received in the exchange consists not only of property permitted . . . to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

The regulations are fairly specific on the question of what constitutes "boot."¹³ Money is obviously non-like-kind property, as are evidences of indebtedness given by the purchaser-exchange. Although mortgage relief to the seller-exchange is deemed to be money received, and therefore boot, the Regulations allow the excess mortgage relief to be offset by any mortgage burden (whether assumed or taken subject to) acquired by the seller-exchangor.¹⁴ In other words, included among the boot to the seller-exchangor will be the net positive mortgage relief, if any, he receives.

In coupling net positive mortgage relief with additional consideration in the form of the purchaser-exchange's notes, it is entirely possible that the seller-exchangor may face a substantial tax liability on boot received. In addition, it is also possible that the seller-exchangor will receive an insufficient amount of cash to satisfy the resulting tax liability. Although benefitting somewhat by being able to increase his basis in the new property by any gain recognized on the exchange, the seller-exchangor who has agreed to accommodate the buyer-exchange's desire for deferred payments via notes still may face cash flow problems.

II. PRINCIPLES OF § 453

The seller-exchangor's tax predicament under § 1031 is no less perplexing than is the analogous situation of a straight sale of property on a deferred payment plan. That there are varying degrees of sophistication in such arrangements does not alter the fact that all contemplate the payment of the purchase price over a period of time. Under pre-§ 453 taxing schemes, the seller would be required to immediately recognize gain on his entire profit, without regard for the economic fact that he won't receive the entire amount in the year of sale.

It was precisely for such circumstances that § 453 was intended to provide some measure of relief. While not technically a nonrecognition provision, it nevertheless allows for deferral of gain recognition provided the transaction fits within various criteria designed to strike some equitable balance between general tax principles and the economic realities of installment transactions. Since the taxpayer selling on installments will take time to receive all of his profits, he should be allowed to report those profits by recognizing gain in proportion to the total amount of gain to be recognized, when all payments have been received.

Conventional installment reporting is allowance when payments in the year of sale (PYOS) do not exceed 30 percent of the selling price (the "30 percent test").¹⁵ Included as PYOS are cash and other property received, plus mortgage relief in excess of basis.¹⁶ Expressly excluded from PYOS are the purchaser's evidences of indebtedness.¹⁷ This exclusion is a logical extension of installment reporting rationale. Part of the seller's profit is represented by the buyer's note, yet the seller typically won't collect on the note until its maturity date. The seller need not count the note as a PYOS since he will not receive the cash necessary to pay the tax liability until some later time.

If the taxpayer satisfies the 30 percent test, he turns to another formula to determine what portion of each installment payment received must be reported as gain. Section 453(b) provides the formula to calculate the percentage: payments received are reported as gain in proportion to what the gross profit bears to the

¹³ Treas. Reg. § 1.1031(b)-1(b), Treas. Reg. § 1.1031(b)-1(c).

¹⁴ See note 1. See also Treas. Reg. § 1.1031(b)-1(c), Treas. Reg. § 1.1031(d)-2, ex. 2.

¹⁵ I.R.C. § 453(b)(2)(B).

¹⁶ Treas. Reg. § 1.453-4(c). Thus, if the taxpayer sold realty for \$100, subject to a mortgage of \$70, and if the taxpayer's adjusted basis in the property was \$50, the taxpayer could only receive \$10 in the year of sale. The mortgage relief exceeds the taxpayer's basis by \$20 and that debt relief plus the \$10 received would equal 30 percent of the selling price of \$100.

¹⁷ I.R.C. § 453(b)(2)(B). It is clear, however, that the "evidence of indebtedness" exclusion does have its limitations. Any evidences of indebtedness will be counted as PYOS if payment is actually or constructively received in the year of sale or if payable on demand. I.R.C. § 453(b)(3). Also, a third party's note which the purchaser guarantees does not fit within the exclusion. *Tombari V. Commissioner*, 62-1 USTC ¶ 9261 (9th Cir. 1969). Further, evidences of indebtedness which are readily tradeable, such as bonds, are considered PYOS. I.R.C. § 453(b)(3).

total contract price.¹⁸ In theory, the proportion *not* reported represents a return of the seller's basis. For example, if the taxpayer sells property having a fair market value of 100, and an adjusted basis of 50, and receives \$30 in cash plus \$70 in purchaser's notes, the taxpayer can elect S 453 since the payments received in the year of sale (\$30) are not greater than 30 percent of the \$100 selling price. The taxpayer's gross profit on the transaction equals his realized gain of \$50; the total contract price in this case equals the selling price of \$100. Thus, each payment that the taxpayer receives, including the \$30 received in the year of sale, has a reportable gain component of 50 per cent (\$50 gross profit/\$100 total contract price). If the purchaser assumed a liability of the taxpayer in connection with the transaction in the amount of \$20, the total contract price would be \$80, and the reportable gain component of each payment would be 5/8 (\$50 gross profit/\$80 total contract price). The balance of each payment represents a return of the taxpayer's basis.

III. COMBINING S1031 AND S453

The foregoing discussion has dealt with two widely used, but distinctly separate planning tools. While S 1031 defers recognition of gain until a later taxable transaction, S 453 deferral is accomplished by spreading recognition of gain over the term of the note payments received. Section 1031 applies automatically to deny recognition of gain or loss, while the taxpayer must specifically elect the benefits of S 453 reporting.¹⁹

Earlier parts of this discussion pointed out the analogous dilemmas facing (a) a taxpayer who makes a straight sale of property on an installment method and receives notes but not enough cash to satisfy the full tax liability, and (b) a taxpayer who effects a partial exchange of properties, receiving "boot" in the form of notes, but who also does not receive sufficient cash to satisfy the tax liability on the "boot." The latter situation calls for similar benefits as are afforded the former, allowing deferred recognition of gain. This has led to the "hybrid 1031/453 exchange," allowing nonrecognition treatment of the like-kind property received, and installment reporting of the "boot" received.

A. Revenue Ruling 65-155

Although little attention has focused upon the viability of the hybrid 1031/453 exchange, the Service has expressly recognized its viability in Rev. Rul. 65-155.²⁰ This Ruling introduces one important variation into the formula for calculating the profit reporting percentage. Whereas under conventional S 453 reporting the percentage is determined by the proportion gross profit bears to the total contract price, the percentage calculation introduced by the Ruling is the relationship the total recognized gain (from the S 1031 "boot" provision) bears to the total contract price. The Ruling's example is illustrative of this change:

Taxpayer X exchanged property with a fair market value of 100 and basis of 10 for Y's like-kind property worth 20, plus cash of 10 and notes of 70. Taxpayer X received the like-kind property and the 10 cash in the year of the exchange. X's total realized gain is 90 (FMV (100) - A/B (10)), but under S 1031 X need only recognize gain to the extent of the 80 "boot" received (1 cash + 70 note).

¹⁸ Gross profit is the taxpayer's realized gain on the sale, or amount realized (selling price) minus adjusted basis. I.R.C. § 1001(a). Total contract price is generally defined in Treas. Reg. § 1.453-4(c)(19). To compute total contract price, use the following formula:

Selling price minus debt relief plus excess of debt relief over adjusted basis. In situations where debt relief does not exceed adjusted basis, the total contract price simply equals the amount which the taxpayer will actually receive from the purchaser (the net proceeds of the sale). If the debt relief equals or exceeds adjusted basis, the PRR will always equal 100 percent. Thus, if the taxpayer sells realty for \$100 subject to a mortgage of \$70, and has an adjusted basis in the property of \$50, the taxpayer will have:

(1) A gross profit of \$50 (\$100 (selling price) minus \$50 (adjusted basis))
(2) A total contract price of \$50 \$100 (selling price) minus \$70 (debt relief) plus \$20 (excess of debt relief over basis)

The PRR (gross profit total contract price) will equal 100 percent and thus the entire amount of installment payments received by the taxpayer will be reported as taxable gain.

¹⁹ I.R.C. § 453(b)(1), Treas. Reg. § 1.453-8(b).

²⁰ Revenue Ruling 65-155, 1965-1 CB 356.

The Ruling provides that the like-kind property, 20, and the cash, 10, received in the year of the exchange constitute payments received for the purposes of applying S 453's 30 percent PYOS test. Thus, installment reporting is available, since those payments do not exceed 30 percent of the 100 selling price.

Conventional S 453 treatment would yield a profit reporting percentage of 9/10 (90%) representing the ratio X's gross profit (90) bears to the contract price (100). However, the Ruling's modification substitutes "total gain recognized" for "gross profit" in the formula, resulting in a profit reporting percentage of 8/10 (80 percent). The profit reporting percentage is then applied against payments received in the year of exchange and also against all payments received on the installment notes in subsequent years, so that all of the gain to be recognized to be reported in the year of exchange will be 34 (30X80%) and, over the term of the notes, an additional 56 (70X80%), for a total recognized gain of 80 (24+56).

Unfortunately, Revenue Ruling 65-155 is somewhat incomplete, failing to discuss the effect a receipt of mortgaged property will have upon the election of boot reporting under S453. The Ruling is worded so as to indicate that the "value" of the like-kind property received must be considered a PYOS. However, it is unclear what is meant by "value" in this provision. The Ruling's example dealt only with non-mortgaged property, and thus the fair market value controlled. The result is less clear under the Ruling, if mortgaged property is received.

B. Clinton Mitchell

The case of *Clinton H. Mitchell*²¹ provides some insight into handling a 1031/453 hybrid when mortgaged, like-kind property is received in the exchange. In *Mitchell*, the taxpayer exchanged two parcels of improved real property for a motel ("Motel"). The exchange agreement set a value of \$148,000 for the taxpayer's properties (subject to an encumbrance of \$18,502.39) and a value of \$247,000 for the Motel (subject to a deed of trust of \$80,873.61). Of the \$247,000 value assigned to the Motel, \$47,000 was allocated to tangible personal property—e.g., furniture, linens, etc.—used in the Motel's operation.

Pursuant to the exchange agreement, the taxpayer-exchangor transferred his two properties (subject to the encumbrance of \$18,502.39) plus a note for \$106,127.40 to the owner-exchange of the Motel. In return, the owner-exchange transferred the Motel (subject to the deed of trust of \$80,873.61) and a secured note of \$69,497.61 to the taxpayer.

In his original return filed for the year of the exchange, the taxpayer stated that his gain realized was the face value of the note received from the exchange, but that his recognizable gain was limited to the amount of payments received on that note. In subsequent returns, the taxpayer reported no further gains on the ground that none were reportable until he had first recovered his investment. The Commissioner challenged this method of reporting, ruling that the taxpayer must recognize gain in the year of exchange equal to the face value of the note received from the exchange.

The taxpayer brought suit in the Tax Court and, prior to trial, both parties stipulated that the note received indeed was S1031(b) "boot" and that its face value, \$69,497.61, constituted gain to be recognized. The dispute then centered around the taxpayer's assertion that he should be allowed to report this recognized gain under the installment provisions of S. 453. The taxpayer's calculations for the purposes of S453 installment reporting paralleled those which would have been made if he had effected a straight sale of his two properties for cash and notes. By so doing, he looked to the value of his own properties in determining his selling price (although even here he improperly subtracted the amount of his mortgage), and ignored the value of the property he received. The taxpayer argued that for the 30 percent test, payments in the year of sale included only \$6,950, the amount received in principal and interest on the exchange's note in the year of the exchange. He further argued that the selling price equalled his equity in the two properties—\$129,498—and that the 30 percent test was obviously satisfied since payments received on the note amounted to approximately five percent of the selling price. His calculations would have been proper (with the exception of the "selling price") had he been in a straight sale situation. However, the Court ruled that he incorrectly ignored the value of the Motel and the notes received in calculating both PYOS and the "selling price."

²¹ *Mitchell v. Commissioner*, 42 T.C. 953 (1964).

The significance of *Mitchell* lies in the Court's analysis of § 453 and 1031 requirements and their application in the context of an exchange which includes § 1031 "boot" to the taxpayer. The Court's findings included:

(1) That the taxpayer's selling price could not be determined by reference solely to the value of the properties he exchanged, as the taxpayer had contended. Instead, the "selling price" included:

The value of the motel he received.....	\$247,000.00
Less encumbrance on motel.....	—80,873.61
Plus mortgage relief to taxpayer.....	+18,502.39
Plus face value of note received.....	+69,497.61
	254,126.39

Thus, to qualify for § 453 installment reporting of the "boot", PYOS could not exceed \$76,237.92, i.e., 30 percent of the \$254,126.39 "selling price."

(2) That payments in the year of sale for purposes of the 30 percent test do not include purchaser's evidences of indebtedness. Thus, while the note received constituted 1031(b) "boot", it was not included as a payment in the year of sale. However, any payments on the note made that year, and any other payments in cash or property must be included. The Court's holding here reflects traditional application both of § 453 and § 1031 provisions.

(1) "Value of the Motel Received as PYOS"

Relying upon their interpretation above, the Court held that the Motel received in the exchange must be counted as a PYOS. Herein lies the Court's insight into what constituted the "value" of the Motel. While Revenue Ruling 65-155 indicates that "value" means "fair market value," the Ruling did not address the situation where mortgaged property is received. The *Mitchell* court held that the equity value (FMV less encumbrances) not the full FMV, represented the additional amount to be included as a PYOS. Thus, the total payments received by the taxpayer in the year of the exchange included:

Value of the motel.....	\$247,000.00
Less encumbrance on motel.....	80,873.61
Plus payments on principal received on exchangee's notes, year 1--	+3,554.39
	169,680.78

Although the taxpayer failed the 30 percent test, the significance of *Mitchell* lies in its conclusion that mortgaged property received in an exchange is to be valued at the amount of its equity value for purposes of applying the 30 percent PYOS test of § 453. Obviously, valuing mortgaged property received by the taxpayer at its equity value for purposes of the 30 percent PYOS test is logical. This is best illustrated by comparing the results of installment reporting when mortgaged property is valued at fair market value rather than equity value. Assume the following circumstances: the taxpayer exchanges his property (fair market value 100; adjusted basis 50) for other property, whether or not like kind (fair market value 20), assuming a mortgage of 10 on such property, and in addition receiving 90 in the form of purchaser's notes, payable over a period of six years. Regardless of whether fair market value or equity value is used, the 30 percent PYOS test is met, and the taxpayer may elect § 453 installment reporting.

The taxpayer's gross profit is 50 (100 fair market value—50 adjusted basis), and thus 50 is the numerator in the gross profit reporting percentage. The denominator is the total contract price, which generally is the amount of money or other property which the taxpayer will actually receive in the exchange of his property.²²

If the mortgaged property is valued at fair market value, the total contract price will be:

$$20 \text{ (fair market value of property received) } + \\ 90 \text{ (fair market value of notes assumed to equal face) } = 110$$

Therefore the gross profit percentage is 50/110, which will yield a total recognizable gain of 50 when applied to the 20 of property received in the year of sale, and to the 90 of payments on the notes over their term.

²² Thus, any liabilities of the taxpayer assumed by the exchange partner would not be included in the total contract price, unless the amount of liabilities assumed exceeds the taxpayer's adjusted basis in the exchanged property, in which case that excess is included as a PYOS. Treas. Reg. § 1.453-4(c). See also note 21.

This method of valuing mortgaged property causes the total contract price (110) to exceed the selling price (100). This is an anomalous result since the Regulations under S 453 contemplate a total contract price only equal to or less than the selling price.²³ Furthermore, the selling price represents the total value the taxpayer realizes in a sale or exchange of property, and it would be inequitable to tax him on an amount in excess of that which he will actually receive.

If the mortgaged property is valued at equity value instead, then the total contract price will be:

$$10 \text{ (equity value of property received)} + 90 \text{ (fair market value of notes assumed equal to face)} = 100$$

In this case, the gross profit reporting ratio is 50/100, which will cause recognition of a total gain of 50 when applied to the 10 of property received in the year of sale and to the 90 in note payments over the six year term of the notes. Here, the total contract price equals the selling price, which is the anticipated result when no liabilities are assumed.

Therefore, based partially upon the authority of *Mitchell*, in addition to the requirements of S 453 installment reporting, it is submitted that mortgaged property received by the taxpayer electing the installment method must be valued at its equity value rather than its fair market value.

IV. THE INCONSISTENCY BETWEEN REV. RULING 65-155 AND S 1031

A. The Rulings' Approach

Although the Revenue Ruling gives lip service to the apparent purpose of S 1031 in its modification of the S 453 profit reporting percentage, the Ruling nevertheless overlooks the basic premise underlying S 1031. If under S 1031 no gain is to be recognized on like-kind property received, why then does the Ruling force recognition of gain in Year One on like-kind property when "boot" is also received and installment reporting of the boot is desired?

This anomaly results from the Ruling's adherence to conventional reporting under S 453. With the Ruling's modification of the profit reporting percentage, the entire gain to be recognized cannot be reached unless the reporting percentage is also applied to the like-kind property. Yet it is that fact which defeats the purpose of S 1031 nonrecognition.

This inconsistency suggests that the flaw lies in the profit reporting percentage itself, and that the Ruling failed to give sufficient consideration to the basic premise of S 1031 stated earlier. The Ruling's creation of the modified profit reporting percentage erroneously supposes that part of the like-kind property (20 percent in the Ruling's example) is not received in Year One, but instead is received as the notes are paid in later years. The net effect of this is to require recognition of gain on like-kind property in Year One, with that forced recognition eventually being returned over later years via the modified profit reporting percentage. In sum, the Ruling says, "We'll tax the like-kind property now, but we'll return it later by not taxing the 'boot' fully."

B. Suggested Alternative

A better approach, which would permit the continuing viability of S 1031 while still reaching the entire gain to be recognized, requires an adjustment of the profit reporting percentage beyond that contemplated in Rev. Ruling 65-155. If a transaction similar to that found in the Ruling's example is considered as a partial exchange for like-kind property and as a partial sale for unlike-kind property, and if S 1031's nonrecognition objectives are to be met, then S 453 installment reporting of the gain should logically coincide with the receipt of the unlike-kind property. Achieving this result requires only that the profit reporting percentage be derived from and applied to the unlike-kind property.

While the Ruling has modified the numerator of the profit reporting percentage to reflect S 1031, the denominator was derived from conventional installment sale reporting. Instead of simply using traditional "contract price" in the denominator, only the "boot" portion of the transaction should be used in order to accurately reflect that portion of the property "sold". The portion "exchanged" for like-kind property under S 1031 should then be omitted from the denominator.

²³ Treas. Reg. § 1.453-4(c), provides that any mortgage of the taxpayer assumed by the purchaser is to be excluded from the total contract price except to the extent the mortgage exceeds the taxpayer's adjusted basis in the property. Under *Crane, infra*, such excess mortgage relief is included in the amount realized, which usually will equal the selling price.

Using the Ruling's example, this adjustment would increase the profit reporting percentage to 100 percent, yet it still reaches the entire gain to be recognized when only applied to the unlike-kind property as it is received. Thus, in Year One, the taxpayer would report as gain 100 percent of the unlike-kind property (10 cash) received. In years 2-7, the taxpayer would likewise recognize 100 percent of the 70 notes, thus eventually recognizing the required 80 gain. This approach more nearly comports with the rationale of nonrecognition exchanges, and tax liability upon the taxable portion of the transaction is more accurately matched to the period in which the money is actually received.

Indeed, the Ruling's approach actually distorts taxable income and could have serious tax consequences for the taxpayer. In the Ruling's example, the taxpayer is forced to recognize 24 gain in Year One, yet he has received only 10 cash with which to meet the tax liability. A taxpayer would fare even worse if he received notes of 80 and no cash in Year One, a not atypical transaction. However, if the profit reporting percentage is 100 percent, as computed by the suggested alternative method, and is then applied only against the unlike-kind property, the taxpayer recognizes 10 gain in Year One while receiving 10 cash with which to satisfy the tax liability. The same matching of income received with gain recognition occurs in subsequent years as the notes are paid. Alternatively, if in Year One the taxpayer receives the like-kind property, no cash, and 80 in notes, he should recognize no gain that year, but should and will report under this suggested alternative 100 percent of the notes as gain as they are received. Under either approach the taxpayer will eventually recognize the entire 80 gain, but the latter approach of the suggested alternative more nearly parallels the purpose of S 1031's nonrecognition provisions and resolves the inconsistency created by the Ruling's approach.

V. TAXPAYER'S NEW BASIS—"TO BE" OR NOT "TO BE"

Revenue Ruling 65-155 also addresses the "substituted basis" provision of S 1031. In the conventional S 1031 tax-free exchange, the taxpayer's new basis is calculated in accordance with Reg. 1.1031(d). The Ruling provides that in the case of a hybrid 1031/453 exchange, the taxpayer's new basis will be:

Basis in property exchanged.....	10
Less: Cash received.....	-10
Less: Cash to be received.....	-70
Plus: Gain recognized—Year One.....	+24
Plus: Gain to be recognized in 5 years.....	+56
Basis in property received equals.....	10

If the taxpayer were to immediately sell the new property for its fair market value of 20, he would realize, and recognize, a gain of 10. This gain of 10, plus the earlier recognized gain of 80, would equal the 90 gain he would have recognized had he sold his original property at its fair market value (100 less 10 basis).

However, the Ruling fails to confront a further issue raised by Reg. 1.1031(d) regarding allocation of the new basis between like-kind and unlike-kind properties received. Theoretically, notes represent unlike-kind property and are so treated in determining the amount of "boot" received. This then raises the question of whether Revenue Ruling 65-155 would assign a zero basis to the notes received in a hybrid 1031/453 transaction.

An argument can be made for adopting this position. The premise upon which such an argument would be based is Reg. 81.1031(d)-1(c), which provides that: the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. (Emphasis added.)

Revenue Ruling 65-155, as noted above, modified the basis formula of S 1031(d) in a hybrid 1031/453 transaction by decreasing the taxpayer's adjusted basis in the transferred property by the amount of any cash received and to be received, and increasing it by the amount of gain recognized and to be recognized. Based partially upon the rationale found in the quoted Regulation that no basis is allocated to cash received, and also in applying the modified basis formula of Revenue Ruling 65-155, it could be asserted that no basis should be allocated to the cash to be received on the purchaser's notes. As a logical extension of this reason-

ing, it might then be argued that the purchaser's notes themselves should not be allocated any basis.

However, a problem arises when the above reasoning is actually applied in the context of a 1031/453 transaction, for the Revenue Ruling's modified PRR in the Ruling's example is only 80 percent. When this PRR is then applied to the note payments as they are received, as required by the Revenue Ruling, the 20 percent of the payments which are not reported as gain are necessarily considered a return of basis. This dilemma may be resolved by assuming that the basis of the purchaser's notes is to be determined independent of the basis adjustments made pursuant to Revenue Ruling 65-155. This supposes that the Revenue Ruling has no application to, nor was meant to have application to, the determination of the basis of the notes received.

A. Independent Determination of Notes' Basis

Section 453(d)(2) should be consulted to independently determine the basis of the purchaser's notes. That provision states: The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

The amount of gain "returnable were the obligation satisfied in full" is generally derived by subtracting the amount of gain recognized in the year of sale from the total recognizable gain. Both the gain returnable on the obligation and the gain returnable in the year of sale are functions of the PRR under § 453(b). As the PRR changes, so does the amount returnable as gain in the subsequent years upon payment of the notes. The basis of the purchaser's notes will also be affected by changes in the PRR.

Applying the above formula to the Ruling's example with an assumed PRR of 80 percent, the notes would have a basis of 20 percent of their value, i.e., 14 ($20\% \times 70$). If the notes were sold at their face value, the reportable gain would be 56 ($70 - 14$). This amount, plus the gain of 24 recognized in Year One, would equal the total gain of 80 which should be recognized. Finally, if the new acquired property, with a basis of 10, is sold for its fair market value of 20, this gain of 10 would account for the realized, but not recognized gain, arising from the transfer of the taxpayer's original property.

If the PRR is 100 percent, as proposed in the suggested alternative, and that percentage is applied only against the unlike-kind property of cash and notes, the notes then have a basis of zero. If the 70 notes are immediately sold, the entire 70 would be gain. Since the 10 cash was recognized gain in Year One, the total gain to be recognized is the required 80. Again, the remaining 10 gain realized, but not recognized at the time of the exchange, will be picked up if the taxpayer sells the new property for its fair market value (20-10 basis). Thus, the total 90 gain realized will eventually be recognized.

B. The Unified Approach

The basis problem presented by Revenue Ruling 65-155 might also be resolved by replacing the Ruling's modified basis formula with the normal § 1031(d) approach, but instead assigning the notes received a § 453(d)(2) basis, rather than a fair market value basis.

The normal § 1031(d) basis formula is: the basis of the new property equals the adjusted basis of exchanged property minus money received plus gain recognized. Using the 80 percent PRR of Revenue Ruling 65-155, and applying the normal § 1031(d) formula, the aggregate basis to be allocated among the properties received by the taxpayer under the facts of the Ruling would equal:

$$10 \text{ (Adjusted Basis of exchanged property)} - 10 \text{ (money received)} + 24 \text{ (gain recognized)} = 24$$

This aggregate basis would then first be allocated under § 453(d)(2) to the installment obligations (whose basis is 14 as determined above), leaving 10 of the aggregate basis to be allocated to the like-kind property received. This approach is logical since it leaves the taxpayer in the same position with respect to the basis of the like-kind property received as he would have been under the Ruling's approach, with 10 of realized but unrecognized gain which will be taken into account upon an immediate sale of the like-kind property at its fair market value of 20. Also, the total recognizable gain of 80 would be reportable over the term of the installment obligations: 24 gain to be reported the year of sale and 56 additional reportable gain as the notes are paid (the PRR remains unchanged).

The application of this "unified approach" in determining how basis should be allocated in a hybrid 1031/453 transaction is equally valid if the PRR of the

suggested alternative is used. Applying the suggested alternative to the facts of Revenue Ruling 65-155, 10 of money is still received, but only 10 of gain is recognized in the year of sale since the gross profit percentage was determined solely with reference to the amount of "boot" received, and not with reference to the total contract price. The aggregate basis to be allocated among the properties received, using the "unified approach", is then:

$$10 \text{ (Adjusted Basis of exchanged property)} - 10 \text{ (money received)} + 10 \text{ (gain recognized)} = 10.$$

Under § 453(d)(2) the basis of the notes would first be determined, which, given a gross profit percentage of 100 percent, would be 0. The entire aggregate basis of 10 is then assigned to the like-kind property received, and again the taxpayer is in the same position with respect to the basis of the like-kind property as he would be if the formula of Revenue Ruling 65-155 were used. Since the PRR remains 100 percent, the 80 worth of "boot" to be received will be entirely recognized as gain over the term of the notes.

It might be argued that utilizing the "unified approach" to determine basis in the hybrid 1031/453 transaction is invalid since a fair market value basis is not allocated to the notes received as seemingly required by Regs. 1.1031(d)-1(c). In response to this challenge, it is suggested that the Regulations do not contemplate § 453 installment reporting of gain recognized on boot received in a § 1031 exchange. For example, a fair market value basis is not assigned to evidences of indebtedness received when installment method reporting is elected under § 453(b), because the total recognizable gain is deferred over the term of the installment obligations. If fair market value were allocated to installment obligations, it would be quite simple to dispose of the notes immediately, thereby causing no gain to be recognized upon the original disposition upon which the notes were received. It is this potential abuse which is prevented by the basis provisions of § 453(d)(2), and there is no legitimate reason for a different result simply because installment reporting of the boot received in a like-kind exchange is elected.

Since the unified approach is in harmony with the basis provisions of both § 453(d)(2) and § 1031(d), it is suggested that this approach should be used in determining basis in a hybrid 1031/453 transaction, and should therefore be incorporated. Regardless of which approach is used to allocate basis to the notes, it is apparent that the notes must have a basis other than zero whenever the PRR is less than 100 percent, and that Revenue Ruling 65-155 is clearly wrong if it is interpreted as holding that the notes received in a hybrid 1031/453 transaction can never have a basis. Using the Ruling's figures, and accepting for the sake of discussion that the notes received cannot have a basis, the like-kind property received has a basis of 10 and the notes have a basis of 0. Assuming the fair market value of the notes equals their face, if the taxpayer immediately sold the notes, he would recognize a gain of 70, which would result in a total gain recognized of 94 in the transaction. This, of course, is impossible since only 90 of gain was realized in the transaction, of which only 80 was recognizable because of § 1031 nonrecognition. It is therefore clear that the basis provisions of Revenue Ruling 65-155 must be revised so as to include either of the approaches discussed above.

VI. MULTI-PARTY EXCHANGES

Hybrid 1031/453 exchange treatment may also be utilized in multi-party exchanges. The following discussion examines two variations of the multi-party exchange, and considers the hybrid exchange tax treatment from the standpoint of both the Revenue Ruling and the suggested alternative.

A. The Alderson Exchange Hypothetical²⁴

In this type of three-party exchange, assume B wishes to purchase A's apartment building, which has a fair market value of 100 and an adjusted basis of 20,

²⁴ *Alderson v. Commissioner*, 317 F.2d 790, 63-2 USTC ¶ 9499 (9th Cir. 1963). In *Alderson*, the taxpayers amended a sales contract with respect to their property to provide for an exchange of properties with the purchaser rather than a straight sale. The taxpayers located the desired exchange property (then owned by an independent third party), negotiated the sale by the third party to the purchaser—even writing buyer's escrow instructions—and then exchanged their property for the purchasers' simultaneously acquired property. The court held that the transaction was a valid § 1031 exchange, finding that the purchaser did not act as the taxpayers' agent and that even if he had done so, that § 1031 non-recognition treatment was not precluded. See also note 6.

but A is only willing to exchange his property for a smaller property. B locates a duplex owned by C which has a fair market value of 30, and which is acceptable to A, but C is only willing to sell to B on an installment basis. B then purchases C's duplex, giving 9 cash and a note secured by the property for 21. B and A then exchange properties, A assuming the 21 mortgage and B giving his own note for 91 to A. What are the tax consequences to each party?

C clearly qualifies for conventional § 453 installment reporting. The 9 cash received equals 30 percent of the selling price of 30, and C will recognize gain based on the applicable PRR applied against the 9 cash in the year of sale and the subsequent installments as they are received.

Although B would not qualify for § 1031 nonrecognition treatment because he acquired C's duplex expressly for the purpose of effectuating the exchange, he still suffers no adverse tax consequences. B's basis in the duplex would be 30 under general *Crane*²⁸ principles. Although B receives 121 in property from A, the note he gives to A plus his basis of 30 will offset the amount realized to produce a gain of zero.

A is the candidate for hybrid 1031/453 treatment. Under § 1031, A should recognize gain on the lesser amount of "boot" received or gain realized. Although A receives 90 "boot" (B's note), A's gain realized is only 80 (30 property received + 91 note - 20 basis - 21 mortgage A assumes). A will have to eventually recognize gain of 80, but wants to report this gain on the installment method.

Following the *Mitchell* pattern, A's selling price is 100, consisting of the net value (9) of the property received plus B's note of 91. Assuming there are no other PYOS the net value (9) of the property received is less than 30 percent of the 100 selling price, and thus A can elect installment reporting.

(1) The Ruling's Approach

A's PRR under the Ruling's approach would be 80 percent, the ratio total gain to be recognized (lesser of "boot"—91 or gain realized—80) bears to contract price (100). Assuming no other PYOS, the PRR would be applied to the net value (9) of the property received in the year of exchange, and A would recognize 7.2 of gain in Year One. However, as was previously discussed, this method forces recognition of gain on the like-kind property received, a result inconsistent with § 1031 principles of non-recognition. As the 91 note is paid over later years, 80 percent of 72.8, will be returnable as gain. Thus, the Service reaches the entire gain of 80 to be recognized (7.2+72.8), but only at the expense of forcing recognition of gain on the like-kind property.

(2) Suggested Alternative Approach

Again, modification of the reporting percentage would cure the above inconsistency. By substituting the 91 "boot" for the contract price in the reporting percentage (thus, 80/91) and applying that ratio only against the unlike-kind property, § 1031 objectives are met. Total gain eventually recognized is 80 (91 notes x 80/91) but this result is achieved without distorting § 1031 non-recognition.

(3) A's new basis

It is assumed in determining A's new basis that an allocation of basis to the notes must be made, and that the Revenue Ruling does not prohibit the assignment of basis to the notes. This allocated basis to the notes may be 0, if the PRR is 100 percent, but the allocation process must still be dealt with.

Applying the basis formula from the Revenue Ruling and independently determining the basis of the notes under § 453(d)(2), A's basis in the newly acquired duplex would be:

Old basis.....	20
Plus gain recognized/to be recognized.....	80
Less money received/to be received.....	-91
Plus mortgage assumed by A.....	21

30

A's basis in the purchaser's notes would vary depending upon whether the method and PRR of the Revenue Ruling or the method of PRR of the suggested alternative, was used.

²⁸ *Crane v. Commissioner*, 331 U.S. 1 (1947). Under *Crane*, and under *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), a taxpayer's cost basis in property includes the amount of a purchase money mortgage, or the amount of an assumed mortgage, which the purchaser acquires or takes subject to.

Ruling's approach

80×91 note=gain 80-100

Therefore, 20×91 note=basis 18.2-100

Alternative approach

80×91 note=gain 80-91

Therefore, 11×91=basis 11-91

Applying the "unified approach" in determining basis, and otherwise, following Revenue Ruling 65-155, the aggregate basis of the properties received would be:

20 (Adjusted Basis of exchanged property) -0 (money received +7.2 (gain recognized) +21 (mortgage assumed) ²⁶ =48.2

After first assigning the § 453(d)(2) basis to the notes, which would be 18.2 using the 80 percent PRR of the Ruling's approach, the remaining basis to be allocated to the duplex is 30.

In contrast application of the "unified approach" in determining basis and use of the suggested alternative yields on aggregate basis of the properties received of:

20 (Adjusted Basis of exchanged property) -0 (money received) +0 (gain recognized) +21 (mortgage assumed) =41

The § 453(d)(2) basis of the notes is 11 as compared above, leaving 30 to be allocated to the basis of the duplex.

Assuming the note was sold at its face value of 91 and that the newly acquired property with a basis of 30 was sold at its fair market value of 30, then the result would be:

Ruling's approach:

Gain on note 91-18.2	72.8
Gain recognized-Year 1	7.2
Gain on property if sold 30-30	0
Total gain ultimately recognized	80

Alternative approach:

91-11	80
	0
30-30	0
	80

B. The Baird Publishing Co. exchange hypothetical ²⁷

This version of the multi-party exchange differs slightly from the *Alderson* situation in the roles assumed by the various parties. Although B's intent still is to acquire A's apartment building, B purchases it from C after A and C have exchanged properties. (Assume the same properties and values as discussed under the *Alderson* hypothetical above.) In a transaction, C and A exchange properties, C giving his property with a fair market value of 30, and a note of 70, in return for A's apartment building. C then transfers the apartment building to B in return for 9 cash and a secured note of 91 from B.

C cannot qualify for § 1031 treatment since the apartment building was acquired solely for immediate resale. Since C's role in the transaction is that of "seller", his transfer of the apartment building to B in return for cash and notes will be a taxable event. Depending upon the numbers involved, C may qualify for § 453 reporting, just as he did in the *Alderson* structure.

B, cast in the role of "buyer", faces no tax consequences, but merely calculates his basis in the apartment building in accordance with *Crane* principles.

Again, A is the candidate for hybrid 453/1031 treatment. Applying the principles previously discussed, the following columnar presentation will demonstrate the tax consequences to A and calculation of his new basis:

²⁶ When mortgaged property is being exchanged under § 1031, the basis formula of § 1031(d) is modified to account for mortgages assumed, or to which the property exchange or received is subject to. The modified formula is: Adjusted Basis of the exchange property - money received - taxpayer's liabilities assumed + gain recognized + exchange partner's liabilities assumed.

²⁷ *Baird Publishing Company v. Commissioner*, 39 T.C. 608 (1962). In *Baird*, the three-party exchange essentially took the following form: the taxpayer wanted to exchange its property for another property which it selected and which was to be improved according to the taxpayer's specifications; the owner of the selected property (a real estate agent who agreed to improve the property) then located a purchaser for the taxpayer's old property; the real estate agent sold the taxpayer's property to the purchaser. Viewing the real estate agent as an independent third party (as the court did), this transaction differs from the *Alderson* transaction in that the exchange is between the taxpayer and the third party and the sale to the purchaser from the third party follows the exchange. The court found the transaction to be a valid like-kind exchange, and that no disqualifying agency relationship existed between the taxpayer and the realtor.

	Ruling's approach	Alternative approach
(a) gain realized.....	30 property received. 70 notes received. -20 basis..... 80	Same.
(b) boot received.....	70 notes.....	Do.
(c) gain recognized (lesser of a or b).....	70.....	Do.
(d) S. 453 selling price.....	30 property received. 70 notes..... 100	Do.
(e) 30 percent PYOS test.....	Satisfied: 30 property gain recognized -70	Do.
(f) PRR.....	contract price 100 30 like-kind property $\times 70\% = 21$	gain recognized = 70
(g) Gain recognized, year one.....	70 notes $\times 70\% = 49$	"boot" zero: no non-like kind property received.
(h) Gain recognized later years.....	70 (21+49).....	70 notes $\times 100\% = 70$.
(i) total gain recognized (g+h).....	70 (21+49).....	70 (0+70).
(j) New basis:		
(1) Applying the basis formula of Revenue Ruling 65-155 to determine the basis of the duplex, and independently determining the basis of the notes under S. 453(d)(2).		
Duplex:		
Old basis.....	20	Old basis..... 20
Gain recognized/to be recognized.....	70	Gain recognized/to be recognized..... 70
Less money received/to be received.....	-70	Less money received/to be received..... -70
	20	20
Notes:		
70% of 70 = gain = 49.		100% of 70 = gain = 70.
30% of 70 = basis = 21.		0% of 70 = basis = 0.
(2) Applying the "unified approach to determining basis"		
Aggregate basis of properties received:		Aggregate basis of properties received:
Old basis.....	20	Old basis..... 20
Gain recognized.....	21	Gain recognized..... 0
Less money received.....	0	Less money received..... 0
	41	20
S 453(d)(2) basis of notes equals 21 (as determined above), with 20 of basis being allocated to the duplex.		S 453(d)(2) basis of notes equals 0 (as determined above), with 20 of basis being allocated to the duplex.
	Ruling's approach	Alternative approach
(k) gain recognized if new property (FMV 30) is sold.....	30 - 20 = 10.....	Same.
(l) ultimate gain realized and recognized (i+k).....	80 (70+10).....	Do.
If instead of being paid, the note were sold at face value, the following would result:		
(m).....	21.....	0.
(n) gain on note if sold at face.....	49 (79-21).....	70 (70-0).
(o) gain recognized year one (g).....	21.....	0.
(p) total gain recognized (n+o).....	70 (49+21).....	70 (70+0).
(q) gain realized if new property (FMV 30) is sold (see k).....	10.....	Same.
(r) ultimate gain realized and recognized (p+q).....	80 (70+10).....	Do.

VII. CONCLUSION

The "trade-down" exchange, as illustrated in the preceding hypotheticals, may be viewed accurately as a partial exchange and a partial sale of the taxpayer's property. The exchange aspect of the transaction results in the receipt of like-kind property entitled to S 1031 non-recognition, while the sale results in the receipt of nonlike-kind property, or boot, which will be taxed upon receipt. It is this duality which strongly militates against Revenue Ruling 65-155's interpretation and application of the PRR. Keeping in mind that the nonrecognition provisions of S 1031 are non-elective, the Ruling's approach requiring gain recognition in the year of the exchange on the like-kind property received appears inconsistent with S 1031. While it is entirely logical to consider the like-kind property received as being partial payment for the property transferred, and further, to include the net value of the property received in applying S 453's 30 percent PYOS test, it does not follow that the like-kind payment received should be taxable. To so hold does undue violence to S 1031.

The solution lies in the suggested alternative, which places proper emphasis upon S 1031 objectives, while still allowing the proper amount of gain to be recognized. Section 453 installment reporting purposes are likewise furthered, in that reporting of gain is matched with the periodic receipt of payments.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS,
Washington, D.C., April 28, 1980.

HON. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Longworth House Office Bldg., Washington, D.C.

DEAR MR. CHAIRMAN: I would like to comment on the Installment Sales Revision Act of 1980, also known as H.R. 6883. This legislation provides a fine example of how simplification can be made not only equitable but practical to implement as well. We have in the past been extremely concerned that many proposals that purport to provide equity are in practice discriminatory due to the legislative complexities included in the bill.

The refinements that are excluded in this bill as a result of the many comments made on the bill introduced last year make this an excellent piece of tax legislation. Specifically, we were pleased to see that the section of the bill dealing with transactions between related parties was modified. This was an area of great concern for our members who would like to transfer a business to other family members and one in which we had commented on in the past.

While we were not able to testify at the hearings held last week by the subcommittee we did want to express our opinion to you directly and let you know we are strongly in favor of this legislation.

Sincerely,

JAMES D. "MIKE" McKEVITT,
Director of Federal Legislation.

[See also letter from National Realty Committee, Inc., p. 185.]

WEIL BROS. COTTON, INC.,
Montgomery, Ala., April 7, 1980.

HON. DAN ROSTENKOWSKI,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: In response to your Release of April 2, I respectfully submit some remarks concerning H.R. 6883, the Installment Sales Revision Act of 1980.

My remarks are to register an objection to the limitation against installment sales between relatives. I understand that this exception was made to answer the abuse of the capital gains tax, where one relative sells a property or security to another on an installment basis, while the buying relative immediately resells the property or security without having to pay a capital gains tax.

However, that provision "throws the baby out with the bathwater", because it disables, for instance, the father who is making a bonafide sale of his business to his son on an installment basis.

The tax laws already have a destructive effect on the family business which is being handed down from one generation to another and the tax structure has been responsible in large measure for the deleterious effect on the perpetuation of family businesses which have, after all, been the backbone of American enterprise. This provision only tightens the noose.

It is grossly unfair for instance, that under the provisions of H.R. 6883 that I could sell my business to a young man who entered my business with my son, but that I would be penalized for making the same sale to my own son, when I would so much rather want my business to stay within my family. There is no reason to assume that my son has more resources than another young man working his way through the business.

I am sure that this exceptional provision in H.R. 6883 was not intended to bring about this undesirable result, but was only intended to close a tax loophole. Therefore, I hope that you will rewrite that clause.

Let me suggest that you exclude from installment sales treatment of property or securities which are sold to a family member provided the buyer sells such property within a given amount of time, say one or two years.

It is not possible for me to appear in person before your Committee, and I hope you will receive this letter which I am furnishing herewith in five copies for consideration by your Committee.

I would be pleased to have your reactions to my letter.

Sincerely,

ROBERT S. WEIL.

H.R. 5616

[H. R. 5616, 80th Cong., 1st Sess.]

A BILL To preserve the existing tax status of wine used in the production of distilled spirits

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subpart A of part I of subchapter A of chapter 51 of the Internal Revenue Code of 1954 (relating to distilled spirits) is amended by adding at the end thereof the following new section:

"SEC. 5010. CREDIT FOR WINE CONTENT.

"(a) ALLOWANCE OF CREDIT.

"(1) IN GENERAL.—On each proof gallon of the wine content of distilled spirits containing wine, there shall be allowed a credit against the tax imposed by section 5001 (or 7652) equal to the excess of—

"(A) \$10.50, over

"(B) the rate of tax which would be imposed on such wine under section 5041 but for its removal to bonded premises.

"(2) FRACTIONAL PART OF PROOF GALLON.—In the case of any fractional part of a proof gallon of the wine content of distilled spirits containing wine, a proportionate credit shall be allowed.

"(b) TIME FOR DETERMINING AND ALLOWING CREDIT.

"(1) DOMESTIC PRODUCTION.—In the case of distilled spirits produced in the United States, the credit allowable by subsection (a) shall be determined when the wine is dumped for processing and shall be allowable for the return period in which the wine is so dumped.

"(2) IMPORTED PRODUCTS.

"(A) IN GENERAL.—In the case of distilled spirits imported or brought into the United States, the credit allowable by subsection (a) shall be determined and allowed when the tax on such distilled spirits is imposed by section 5001 (or 7652).

"(B) DETERMINATION OF WINE CONTENT.—The wine content of imported distilled spirits shall be established by such chemical analysis, certification, or other methods as may be set forth in regulations prescribed by the Secretary.

"(c) WINE.—As used in this section, the term 'wine' does not include—

"(1) any substance which has been subject to distillation at a distilled spirits plant after receipt in bond, and

"(2) wine containing more than 24 percent of alcohol by volume."

(b) The table of sections for such subpart A of part I of subchapter A of chapter 51 of such Code is amended by adding at the end thereof the following new item:

"Sec. 5010. Credit for wine content."

SEC. 2. The amendments made by the first section of this Act shall take effect on January 1, 1980.

BRIEF SUMMARY—H.R. 5616

PRESENT LAW

Excise tax rates on wine

The excise tax on wine depends on the alcohol content (by volume) and whether the wine is carbonated or noncarbonated (still wine). Still wines are taxed as follows: (a) 17 cents per wine gallon for wines containing not more than 14 percent alcohol; (b) 67 cents per wine gallon for wines containing more than 14 percent and not more than 21 percent alcohol; and (c) \$2.25 per wine gallon for wines containing more than 21 percent and not more than 24 percent alcohol.

Champagne and other sparkling wines are taxed at \$3.40 per wine gallon and artificially carbonated wines are taxed at \$2.50 per wine gallon. (All wines containing more than 24 percent alcohol by volume are classed and taxed as distilled spirits—at \$10.50 per proof gallon.)

Method of taxing wine used in distilled spirits products

One use for wine is to combine it with distilled spirits to produce distilled spirits products, such as blended whiskeys, cordials and liqueurs. Under law in effect prior to January 1, 1980, wine used to produce distilled spirits products was subject to the applicable wine tax when this wine was withdrawn from the bonded wine cellar where it was produced. The distilled spirits tax of \$10.50 per proof gallon was correspondingly imposed on the distilled spirits before the wine and distilled spirits components were blended to produce the distilled spirits product. In addition, a 30-cent per proof gallon rectification tax was generally imposed on the blended product. Prior law also included provisions under which alcoholic flavorings used to produce distilled spirits products were subject to an effective tax rate of \$1.00 per proof gallon before they were blended into a distilled spirits product.

The Trade Agreements Act of 1979 (P.L. 96-39, approved July 26, 1979) generally implements the trade agreements reached under the multilateral trade negotiations. A part of this legislation equalizes the N.E. excise tax treatment of U.S. and foreign produced distilled spirits and modernizes the system for imposing and administering the distilled spirits tax. This new system is referred to as the "all-in-bond" method and was generally effective on January 1, 1980. Under the all-in-bond method wine used to produce distilled spirits products is not subject to the wine tax. Instead, this wine is transferred in bond (before any tax is determined) to the distilled spirits plant where it becomes part of a distilled spirits product. The distilled spirits tax is then imposed on the completed product, including the wine component.

(The 30-cent rectification tax was also replaced under the all-in-bond changes.)

A result of the change to the all-in-bond method is that alcohol in wine which is included in a distilled spirits product is subject to the \$10.50 per proof gallon distilled spirits tax, rather than the generally lower total of the applicable wine tax and the prior rectification tax.¹ The distilled spirits tax is also similarly imposed on any alcoholic flavorings which are part of the blended product.

EXPLANATION OF THE BILL.

The bill would provide a credit against excise tax liability under the all-in-bond method for the difference between the distilled spirits tax (\$10.50 per proof gallon) and the applicable wine tax on this wine if the wine had been subject to the wine tax (as imposed under Code sec. 5041 but for its removal to bonded premises). The credit would be available only on wine which becomes part of a distilled spirits product and would be determined, in the case of domestically produced distilled spirits products, when the wine is dumped for processing and would be allowed for the return period in which the wine is so dumped. This credit would also be available for wine included in distilled spirits products which are produced abroad and imported into the United States and would be determined and allowed at the time the distilled spirits tax is imposed.

The wine content of imported distilled spirits would be established by such chemical analysis, certification, or other method as may be set forth in regulations.

EFFECTIVE DATE

The provisions of the bill would be effective on January 1, 1980, the same date when the all-in-bond method became effective under the Trade Agreements Act of 1979.

REVENUE EFFECT

It is estimated that the bill would reduce budget receipts by at least \$5 million annually from the amount that would be collected under the all-in-bond method.

¹ Although P.L. 96-39 was effective on January 1, 1980, the Bureau of Alcohol, Tobacco, and Firearms (ATF) of the Treasury Department issued a temporary rule (45 Fed. Reg. 7528, Feb. 1, 1980; Treas. Dec. ATF-64) deferring the payment of the distilled spirits tax attributable to the wine component of distilled spirits products. This deferral applied only to the first three semi-monthly return periods for spirits withdrawn during 1980, but the tax so deferred was due and payable on March 20, 1980; no further extension has been granted.

STATE OF CALIFORNIA,
DEPARTMENT OF FOOD AND AGRICULTURE,
Sacramento, Calif., April 16, 1980.

HON. DAN ROSTENKOWSKI,
Chairman, House Committee on Ways and Means, Subcommittee on Select
Revenue Measures, Longworth House Office Building, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The State of California strongly urges you to favorably report H.R. 5616, a bill which would preserve the existing "component" tax status of wine used in the production of brandy and other distilled spirits.

The California wine industry sells significant amounts of wine to rectifiers and distillers for blending in the production of cordials, liqueurs, whiskies and brandies. The rectifiers' and distillers' tax liability is based on the individual component parts of the product rather than on the finished product itself. The tax on the wine component is \$.67 per gallon. The tax on the distilled spirits component is \$10.50 per gallon.

Although the Administration repeatedly assured both Congressional and wine industry sources that the Trade Agreements Act of 1979 (the Trade Bill) would contain nothing inimical to the interests of the American wine industry, a highly technical and complex section inadvertently for all practical purposes eliminated the use of wine in the production of spirits. This section assesses the tax on spirits solely on the proof of the entire finished product after bottling. Thus, the tax of \$10.50 per gallon would apply. Since the cost, exclusive of tax, of a unit of grape or wine alcohol is much more expensive than a unit of alcohol from grain spirits, the only advantage to the use of wine in spirits production is the tax advantage which wine traditionally enjoyed under the system of component taxation.

The wine industry did not become aware of the offending provision in the Trade Bill until July 9, 1979, when it had already reached the House floor. On July 10, Chairman Vanik stated that his committee (which had reported the Trade Bill) "never anticipated" this result, having just become aware of the section's "unintended impact on the wine industry." He stated that he would like the problem corrected by subsequent legislation. H.R. 5616 is that legislation.

Although we understand that the Bureau of Alcohol, Tobacco and Firearms has not yet put the offending provision of the Trade Bill into effect, we also have learned that if H.R. 5616 does not receive prompt favorable action the Bureau will be forced to do so.

The United States wine industry is subject to a tremendous imbalance in international wine trade. In 1978, wine represented a trade deficit of nearly \$568 million; two percent of the total U.S. trade deficit. The industry rightfully had hoped for some meaningful concessions from the Multilateral Trade Negotiations on which the Trade Bill was based. None were forthcoming. In fact, instead of helping the wine industry to expand markets abroad, this provision of the Trade Bill would restrict U.S. markets at home.

The wine and grape industries in California make a significant contribution to the economy of the State in terms of dollar values of farm products produced and the employment of farm and nonfarm workers. Grapes which are crushed for wine constitute more than half of the total \$864 million grape industry which occupies approximately 621,400 acres of land in the State.

Since the Multilateral Trade Negotiations which were conducted last year were singularly unsuccessful in allowing a better balance between imports and exports of wine, the imposition of the spirits tax would deal the grape and wine industries a severe blow. We believe the tax change on distilled spirits which is the "unintended result" of the Trade Bill should and must be rectified by favorable action on H.R. 5616.

California's wine industry is vital to the State's economy. H.R. 5616 would preserve an important market for California wine. We urge your favorable consideration of the bill.

Sincerely,

R. E. ROMINGER, Director.

H.R. 5729

[H.R. 5729, 96th Cong., 1st sess.]

A BILL To amend the Internal Revenue Code of 1954 to provide for the amortization of startup expenditures paid or incurred in starting a new trade or business

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part VI of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to itemized deductions for individuals and corporations) is amended by adding at the end thereof the following new section:

"SEC. 193. STARTUP EXPENDITURES.

"(a) ELECTION TO AMORTIZE.—Startup expenditures paid or incurred by a taxpayer prior to the trade or business functioning as a going concern may, at the election of the taxpayer (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer in the trade or business (beginning with the month the trade or business starts functioning as a going concern) or if the trade or business is liquidated before the end of the 60-month period, such deferred expenses (to the extent not already deducted under this section) may be deducted to the extent provided in section 165.

"(b) STARTUP EXPENDITURES DEFINED.—The term 'startup expenditures' means any expenditure which is—

"(1) an ordinary and necessary expense incident to the investigation, formation, and creation of the trade or business;

"(2) chargeable to capital account; and

"(3) of a character which, if expended incident to the investigation, formation, and creation of the trade or business having a determinable life, would be amortizable over such life."

(b) The table of sections for such part VI is amended by adding at the end thereof the following new item:

"Sec. 193. Startup expenditures."

SEC. 2. The amendments made by this section shall apply to amounts paid or incurred after December 31, 1979.

BRIEF SUMMARY—H.R. 5729

PRESENT LAW

In general

Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not currently deductible since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenses or costs incurred in acquiring or creating an asset, *e.g.*, a business, which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. However, costs which relate to an asset either with an unlimited or indeterminate useful life may be recovered only upon a disposition or cessation of the business.

Certain business organizational expenses incurred in the formation of a corporation or partnership may be treated as deferred expenses, on an elective basis, and amortized over a period of not less than 60 months (code secs. 248 and 709). Expenditures eligible for amortization include only those expenditures which

are directly incident to the creation of the corporation or business. Pre-opening or startup expenses, such as employee training expenses, are ineligible for amortization under this provision.

Investigatory expenses

Business investigatory expenses may be either of a general or specific nature. The former are related either to businesses generally, or to a category of business; the latter are related to a particular business. All investigatory expenses are costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business.

Business investigatory expenses generally are nondeductible regardless of the status of the taxpayer by whom they may be incurred. However, taxpayers may be able to deduct a loss for business investigatory expenses incurred in an unsuccessful attempt to acquire a specific business.¹ Nevertheless, business investigatory expenses of a general nature normally are viewed either as being nondeductible personal expenses, or as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code.

Startup costs

Startup or preopening expenses are those costs which are incurred subsequent to a decision to acquire or establish a particular business, and prior to its actual operation. Generally the term "startup costs" refers to expenses which would be deductible currently if they were incurred after the commencement of the particular business operation to which they relate. Such costs may be incurred by a party who is not engaged in any existing business, or by a party with an existing business who begins a new one that is unrelated, or only tangentially related, to his or her existing business.

Startup costs may include expenses relating to advertising, employee training, lining-up distributors, suppliers, or potential customers, and professional services in setting up books and records. However, startup expenses also may refer to certain items which are nondeductible and nonamortizable even if they are incurred prior or subsequent to commencement of business operations. These nondeductible and nonamortizable expenses either may be of a purely capital nature, or may be capitalizable simply because they relate to a business with an indeterminate life.

EXPLANATION OF THE BILL

The bill would allow taxpayers an election to amortize, over a period of not less than 60 months, ordinary and necessary startup costs incurred incident to the investigation, formation, and creation of a trade or business entered into by the taxpayers. The amortization election would apply only to ordinary and necessary startup costs which do not create an asset which has a useful life of its own and which are of a character which would allow the taxpayer to amortize them if they were expended incident to the investigation, formation, and creation of a trade or business having a determinable useful life. The election would apply only with respect to expenditures incurred with regard to a business actually entered into by the taxpayer, and would not apply if the business had an ascertainable useful life of less than 60 months. If the business is liquidated prior to the end of the 60-month period, any "startup" expenses which had not been amortized could be deducted to the extent allowed under present law.

The election would have to be made at the time, and in the manner, specified in Treasury regulations.

EFFECTIVE DATE

The provisions of the bill would apply to amounts paid or incurred after December 31, 1979.

REVENUE EFFECT

Due to the lack of adequate information on the number of potential businesses formed and on the amount of expenses incurred in the process covered by the bill, no revenue estimate is available at this time.

¹ See *Harris W. Seed*, 52 T.C. 880 (1969), acq., 1970-2 C.B. xxi; Revenue Ruling 77-254, 1977-2 CB 63.

[See also letter from American Bankers Association, p. 150.]

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., April 28, 1980.

Hon. DAN ROSTENKOWSKI,
U.S. House of Representatives,
Rayburn House Office Building, Washington, D.C.

DEAR MR. ROSTENKOWSKI: The federal tax division of the AICPA has considered the provisions of H.R. 5729, a bill to amend the Internal Revenue Code of 1954 to provide for the amortization of the costs of starting up a new trade or business. Under this bill, a taxpayer may elect to amortize such costs over a period of not less than 60 months.

We note that the expenditures contemplated by H.R. 5729 are "... ordinary and necessary expense incident to the investigation, formation, and creation of the trade or business. . . ." We assume such expense would include pre-operating expenditures, as well as the cost of preliminary investigation of business or investment opportunities.

The federal tax division has endorsed the general concept embodied by H.R. 5729, i.e. some provision should be made for the deduction of startup costs. However, our recommendations draw a distinction between pre-operating and preliminary investigation expenses. Further, they address the problem, that, under present law, startup expenses are only deductible where the prospective business or investment is actually consummated. In addition, our recommendations accord separate treatment to small business enterprises.

The recommended tax law changes of the division are set forth below for your consideration.

1. DEDUCTIBILITY OF PRE-OPERATING EXPENSES

A current deduction should be allowed for expenses incurred during the development or pre-operating stage of a trade or business if those same expenses would be deductible once operations had commenced.

Under present law, a line of cases has established the principle that expenses incurred during the pre-operating stage of a business are not currently deductible (e.g. *Richmond Television Corp. v. Com.*, 345 F. 2d 410). These expenses are distinguishable from investigatory expenses in that the taxpayer has clearly committed to engage in a particular business activity, but has not completed his preparations to do so.

Disputes frequently arise over (1) the point in time when a trade or business has become operative and (2) whether an activity represents a new trade or business for a taxpayer, or whether it is merely an extension of an existing business. For example, in *First National Bank of S.C.*, 413 F. Supp. 1107, it was held that a bank's entry into the credit card field was merely an expansion of an existing activity; accordingly, pre-operating expenses were deductible.

There does not appear to be any policy reason why an expense that would be deductible after business has commenced should not be deductible during the development stage.

2. DEDUCTION FOR PRELIMINARY INVESTIGATION OF BUSINESS OR INVESTMENT OPPORTUNITIES

Expenses paid or incurred by an individual during a taxable year with respect to a search for a prospective business or investment should be deductible regardless of whether the proposed transaction was consummated.

Prior to 1957, the IRS followed I. T. 1505 (1-2 CB 112) in permitting a deduction for expenses incurred in determining whether or not an investment should be made. The ruling held that such an investigation constitutes a transaction entered into for profit and that upon abandonment of the enterprise, the expenses incurred become a loss that is deductible in the year of abandonment.

Revenue Ruling 57-418 (1957-2 CB 143) revoked I. T. 1505 after reviewing the history of the application of the rule and established a new rule that "a loss sustained during a taxable year with respect to expenditures incurred in search of a prospective business or investment is deductible only where the transaction has actually been entered into and the taxpayer abandons the project."

Revenue Ruling 77-254 (IRB 1977-30, p. 6) amplifies Revenue Ruling 57-418 by providing that a taxpayer will be considered to have entered a transaction for

profit if the taxpayer has gone beyond a general investigatory search for a new business or investment to focus on the acquisition of a specific business or investment.

We would like to point out that Revenue Ruling 77-254 does not solve the problem in that it makes an inappropriate distinction in the tax treatment of audit expenses incurred with regard to the acquisition of a new business as compared with the legal fees relating to the same transaction.

Expenditures made in connection with a preliminary investigation of business or investment opportunities should be deductible even if a taxpayer abandons the prospective project before entering into a material amount of activity in connection with it. Such preliminary expenditures should be equivalent to those that are admittedly deductible where the taxpayer had engaged in material activity. See *Charles T. Parker*, 1 TC 709 (1943), distinguished by the IRS in Revenue Ruling 57-418.

There is no equitable justification for limiting the deduction of investigatory expenses to situations where the prospective business or investment was actually entered into and subsequently abandoned. If a taxpayer makes a good faith investigation of a business prospect entered into for a profit that is clearly identifiable and incurs expenditures reasonable and necessary thereto, he should be permitted a deduction for those expenses.

Taxpayers already engaged in a particular business are permitted to deduct expenses of investigating the expansion of their business into new areas. Thus, by not being allowed to deduct the expenses of investigating the establishment of a new business, a newcomer to a particular type of business is placed at a competitive disadvantage with not only those already in such business but existing businesses seeking to establish new branches.

The deduction should be permitted under either section 165(c)(2) for expenses relating to business prospects or under section 212 for investment connected expenses.

B. BUSINESS INVESTIGATION EXPENSE BY A SMALL BUSINESS ENTERPRISE

Business investigation expenses incurred by a small business enterprise should be deductible in full, or electively deferred over a 60-month period.

Founders of, and investors in, a small firm may encounter difficulties when the firm is prevented from deducting expenses incurred before a newly established business commences operation, unless these expenses qualify under sec. 174 as research and experimental expenditures.

A contrast should be drawn with large public corporations which borrow funds for investment in stock or loans of a subsidiary, and arrange for the subsidiary to undertake an expansion or diversification of some existing business conducted by the parent corporation. The large public company has no difficulty in deducting the interest on loans for financing the new subsidiary, and the preoperating expense disallowance does not apply to the diversification efforts of the subsidiary.

The Supreme Court recognized the needs of a small business, particularly in its exploratory phase, in the *Snow* case, but only as to the research and experimental expenditures involved. Sec. 162 should be amended to use the same "in connection with his trade or business" phrase for a small business enterprise which pays or incurs business investigation expenses. In the alternative, sec. 174 should be enlarged to cover business investigation expenses paid or incurred by a small business enterprise. However, if the small business elects to defer such expenses, they should be amortized over a 60-month period, rather than being associated with units of inventory purchased, produced, or sold.

The federal tax division of the American Institute of CPAs urges consideration of the above recommendations alternative to H.R. 5729. However, if these recommendations are not feasible as legislative amendments, the division will support H.R. 5729 as an aid in eliminating some of the uncertainty regarding the tax consequences of startup costs.

The division welcomes the opportunity to comment on this bill and commends you and Mr. Conable for focusing attention on the problem. We will be happy to discuss it further with you or your staff.

Sincerely,

ARTHUR J. DIXON,
Chairman, Federal Tax Division.

NATIONAL REALTY COMMITTEE, INC.,
New York, N.Y., April 24, 1980.

Re H.R. 6883 and H.R. 5729.

HON. DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and
Means, Longworth House Office Building, Washington, D.C.

DEAR SIR: Our firm is tax counsel to the National Realty Committee, Inc., a nonprofit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States.

We are pleased to submit on behalf of the National Realty Committee comments with respect to the Installment Sales Revision Act of 1980 (HR 6883) and the proposed bill to provide for the amortization of start-up expenditures paid or incurred in starting a new trade or business (HR 5729).

We strongly support enactment of the Installment Sales Revision Act. We believe that this Act represents a substantial simplification and improvement over present law.

With reference to HR 5729, which would permit the amortization of start-up expenditures incurred in starting a new trade or business, we support the stated purpose underlying the proposed bill subject to clarification of certain items.

HR 5729 deals with an area of the law which is currently unclear and subject to substantial controversy between the Internal Revenue Service and taxpayers.

The bill attempts to reduce such controversy by providing an election to amortize certain expenditures rather than by clarifying the legal issues underlying many of the current controversies.

The Treasury apparently hopes that faced with the possibility that an attempt by a taxpayer to currently deduct start-up expenditures may result in a total disallowance, on the ground that such expenditures were incurred prior to the commencement of a trade or business, the taxpayer will be induced to elect the amortization provided by HR 5729. (See statement made April 17, 1980 by Daniel I. Halperin, Deputy Assistant Treasury Secretary for Tax Legislation, before this Subcommittee.)

We agree with the concept underlying the Treasury's views. We believe that the reduction of areas of controversy between taxpayers and the Internal Revenue Service is a laudable objective. We further agree that an amortization election may be a useful tool in this regard.

However, in view of the substantial number of current controversies involving the treatment of various "start-up expenditures" we believe that it is crucial that the bill itself, or the Committee Report accompanying the bill, make it clear that the legislation is not intended to affect the treatment of any so-called start-up expenditure under prior law or the determination of any item in the absence of an election to amortize under Section 193.

We are also concerned that the bill as drafted may not totally achieve its stated goals.

Under the proposed Section 193(a) "start-up expenditures" may, at the election of the taxpayer, be treated as deferred expenses if "paid or incurred by a taxpayer prior to the trade or business functioning as a going concern. . . ."

Since the availability of the election is determined by the undefined phrase "functioning as a going concern", which appears to involve a similar concept to the "commencement of business" which is the source of much current controversy, a taxpayer making the election may be faced at a future date with the contention by the Internal Revenue Service that the expenditure involved was paid or incurred by the taxpayer subsequent to the trade or business functioning as a going concern and, therefore, was not properly subject to the election. If in the absence of a proper election the expenditure involved should have been deducted in a taxable year then closed under the applicable statute of limitations, the taxpayer will have lost the deduction as well as the right to amortize under Section 193.

We believe that this problem can be eliminated by providing an appropriate extension of the applicable statute of limitations for refund claims which may arise as a consequence of a determination by the Internal Revenue Service that a taxpayer was not entitled to amortize an expenditure under Section 193 on the ground that the business had commenced functioning as a going concern.

We also have some concern over the definition of "start-up expenditures" contained in Section 193(b).

The explanation of the bill prepared by the Joint Committee Staff states: "The amortization election would apply only to ordinary and necessary startup costs which do not create an asset which has a useful life of its own and which are of a character which would allow the taxpayer to amortize them if they were expended incident to the investigation, formation and creation of a trade or business having a determinable useful life."

Subdivisions (1) and (3) of proposed Section 193(b) appear to effectuate the purpose described in the foregoing sentence from the Joint Committee Staff explanation of the proposed bill with the exception of that portion of the explanation which states that the "amortization election would apply only to ordinary and necessary startup costs which do not create an asset which has a useful life of its own". For example, it is clear that sums expended for the construction of a building to be held in a rental business are not "of a character which, if expended incident to the . . . creation of the trade or business having a determinable life, would be amortizable over such life," rather than over the life of the building? Presumably it is the intention to permit amortization under Section 193 only if such expenditures would not otherwise be deductible or depreciable. It further appears to us that subdivision (2) of proposed Section 193(b) is unnecessary in view of the provisions contained in subdivision (3) of such section.

In summary, we believe that Section 193 (b) might be simpler and clearer if it read as follows:

"(b) **Startup Expenditures Defined.**—The term 'startup expenditures' means any ordinary and necessary expenditures which is—

"(1) incident to the investigation, formation, creation or operation of a trade or business;

"(2) of a character which would be amortizable over the life of such trade or business if such trade or business had a determinable life; and

"(3) not otherwise deductible or amortizable."

We further suggest the addition of the following subsection (c):

"(c) **Effect of No Election.**—The right of any taxpayer to the allowance of any deduction where no election is made under this section shall be determined as though this section had not been enacted."

We appreciate the opportunity to submit our views to your Subcommittee.

Very truly yours,

ROBINSON, SILVERMAN, PEARCE, ARONSOHN
& BERMAN,
ALAN J. B. ARONSOHN.

PRICE WATERHOUSE & Co.,
Washington, D.C., April 23, 1980.

Congressman DANIEL ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Rayburn House Office
Building, Washington, D.C.

DEAR MR. ROSTENKOWSKI: We are pleased to have the opportunity to express our support for passage of H.R. 5729 which proposes to amend the Internal Revenue Code of 1954 to provide for the amortization of startup expenditures paid or incurred in starting a new trade or business. This bill is directed toward changing the tax law for expenditures which are not presently deductible, a situation which often results in inequities between taxpayers. Enactment of H.R. 5729 would signal a major step toward equal tax treatment in this area.

THE BILL

H.R. 5729 would allow taxpayers—whether or not incorporated—to elect to amortize expenditures paid or incurred prior to the start of business. The taxpayer would be permitted to elect amortization for a period of not less than 60 months. Expenditures falling into this category, usually referred to as "pre-opening" or "startup" costs, are defined in the bill as:

"(1) an ordinary and necessary expense incident to the investigation, formation, and creation of the trade or business;

"(2) chargeable to capital account; and

"(3) of a character which, if expended incident to the investigation, formation, and creation of the trade or business having a determinable life, would be amortizable over such life."

Typical examples of such expenditures are those incurred for investigating the new business venture, as well as advertising, training, administration and other similar items incurred prior to actual commencement of the trade or business. Current law renders these expenditures nondeductible if they are incurred prior to commencement of the business. It is significant to note that the taxpayer expenditures referred to by this bill are such that they normally would be fully deductible if they were incurred *after* the commencement of business.

SUPPORT FOR THE BILL

In our opinion, H.R. 5729 provides for a necessary and proper expansion of the deductible items under the Internal Revenue Code. In addition, enactment of H.R. 5729 would add incentives to taxpayers starting businesses or expanding businesses into new areas. Further, the bill would reduce much of the disparity in tax treatment given expenditures incurred in connection with the expansion of an existing business and the formation of a new business by allowing deductions for similar expenditures in each case.

One of the significant benefits to be derived from the passage of H.R. 5729 would be the elimination of continued controversy which presently exists between taxpayers and the Internal Revenue Service. This controversy involves the definition, as well as the deductibility, of startup expenses. Under current law, the IRS treats preopening or startup costs incurred by new business ventures as non-deductible capital expenditures, based on the theory they are not ordinary and necessary expenses incurred in a trade or business inasmuch as the business does not exist. Once the business has been started, subsequent similar expenditures are deductible. Since the question of when a business actually begins is one of fact with no clear cut guidelines or rules, considerable differences occur between taxpayers and the IRS resulting in time consuming and costly negotiations sometimes leading to litigation. Enactment of H.R. 5729 would constitute a major step in reducing such controversy since it would provide a deduction for all such costs through amortization without regard to the date a trade or business began.

SUGGESTION FOR CLARIFICATION—AMORTIZATION STARTING PERIOD

The bill provides that qualifying expenditures incurred prior to the business, "... functioning as a going concern . . ." may be amortized over a 60 month period "... beginning with the month the trade or business starts functioning as a going concern . . ." While the term "going concern" is understood for financial accounting purposes, and to a lesser extent purposes of tax law, it is not defined with such a degree of precision as to be unambiguous. We would suggest, consequently, that the starting point for amortization of startup cost be keyed to a more readily identifiable event. Here we suggest that guidance is furnished by Section 248 of the Internal Revenue Code and the Regulations issued thereunder. Amortization under this section begins in the month in which the entity "begins business". The Regulations provide that a corporation is deemed to begin business if it has established the nature of its business.

We suggest that a "Begins Business" test, similar to that found in Section 248 be substituted for the "Going Concern" language of H.R. 5729. This modification should serve to further reduce controversy in the area.

SUGGESTION FOR AMORTIZATION ELECTION

The Bill, as drafted, makes provision for the taxpayer to treat the startup expenditures as deferred expenses amortizable over a period not less than 60 months. H.R. 5729 leaves the method of making such an election to the Secretary by requiring that regulations are to be issued prescribing the manner in which the election should be made. It is our opinion that the election procedures should not be overly restrictive. To be overly restrictive would not be in keeping with a key feature of the bill, that being a desire to eliminate unnecessary and costly controversy.

For example, if the Secretary should prescribe that an election to amortize startup expenditures may be made only with a timely filed tax return and would cover only the specific expenditures itemized in the election, the effectiveness of the provision would be seriously impaired. This is because controversy surrounding other items which the taxpayer may have regarded as ordinary and necessary nonstartup expenses will continue. Under these circumstances, taxpayers would not have available the opportunity to yield to an IRS disallowance on the basis

that amortization would be available. With a highly circumscribed election procedure, taxpayers would still face the risk of having to permanently capitalize borderline items that were initially deducted, without the opportunity to bring those items under an amortization election if they are disallowed as current deductions.

In testimony regarding a companion bill, S. 1638, presented to the Senate Subcommittee on Taxation and Debt Management Generally last fall, the Treasury Department indicated preference for a circumscribed election procedure. In our opinion this approach would be contrary to the spirit of the bill, i.e., to produce equity between taxpayers and reduce controversy between taxpayers and the Internal Revenue Service.

SUMMARY

In summary, we feel the proposal to provide for amortization of startup expenses as set forth in H.R. 5729 presents an effective approach toward the elimination of unwarranted controversy between taxpayers and the Internal Revenue Service. Perhaps more important is the proposed elimination of disparity which presently exists between those seeking to expand their businesses and those seeking to start a new business. Further, we feel substitution of the "Begins Business" concept for the "Going Concern" test is desirable.

In addition to the merits of H.R. 5729 we feel the timing of taxpayer election to amortize startup expenses should not be so restrictive as to force existing businesses to elect to amortize startup expenses, incurred in connection with an existing business, merely as the result of concern that failure to do so will result in permanent loss of a legitimate deduction. In our opinion the legislation should make it clear, that taxpayers could make the amortization election at any time prior to expiration of the statute of limitations provided a good faith attempt has been made to comply with Section 193 in the original return of the taxpayer.

* * * * *

We hope our comments are helpful to you. If you, your staff or other members of the Subcommittee wish to discuss this matter with us feel free to contact me.

Yours very truly,

PETER J. HART,
National Director of Tax Policy.

H.R. 6039

[H.R. 6039, 96th Cong., 1st sess.]

A BILL To provide that annuity contracts purchased by the Uniformed Services University of the Health Sciences shall be entitled to the benefits of section 403(b) of the Internal Revenue Code of 1954

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That an annuity contract purchased by the Uniformed Services University of the Health Sciences for any employee who is a member of the civilian faculty or staff of such university shall, for purposes of section 403(b) of the Internal Revenue Code of 1954, be treated as an annuity contract purchased for an employee by an employer described in section 501(c)(3) of such Code which is exempt from tax under section 501(a) of such Code.

SEC. 2. The first section of this Act shall apply to service after December 31, 1979, in taxable years ending after such date.

BRIEF SUMMARY—H.R. 6039

PRESENT LAW

If an annuity is purchased for an employee by an exempt organization described in Code section 501(c)(3) or by a public school system, the employer's contributions for the annuity contract are, within certain limitations, excludable from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract (sec. 403(b)). Subject also to limitations generally applicable to tax-qualified retirement plans, the amount excludable in any year cannot exceed 20 percent of the employee's current annual compensation times the number of years of service, less amounts contributed tax-free in prior years.

In P.L. 92-426, Congress authorized establishment (under the Department of Defense) of the Uniformed Services University of the Health Sciences in order to train medical students for the uniformed services. This legislation authorizes hiring civilian faculty and staff members at salary schedules and with retirement benefits similar to those given to the faculty and staff of medical schools in the Washington, D.C. area. On July 15, 1975, the Secretary of Defense approved a tax-deferred annuity program for the faculty, similar to annuities available at certain medical schools in the Washington area and throughout the United States. However, because the University is a Federal instrumentality and is not an exempt organization described in section 501(c)(3), the annuities do not qualify under present law for tax deferral pursuant to section 403(b).

EXPLANATION OF THE BILL

The bill would treat otherwise qualified annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences in the same manner for income tax purposes (sec. 403(b)) as employee annuities purchased by section 501(c)(3) organizations or by public school systems. Any qualified annuity purchased by the University would be subject to the same limitations as other annuities described in section 403(b).

EFFECTIVE DATE

The provisions of the bill would apply to annuities purchased for service performed after December 31, 1979, in taxable years ending after that date.

REVENUE EFFECT

It is estimated that the bill would decrease budget receipts by less than \$1 million per year.

STATEMENT OF DAVID PACKARD, CHAIRMAN, BOARD OF REGENTS, UNIFORMED
SERVICES UNIVERSITY OF THE HEALTH SCIENCES

SUMMARY

H.R. 6039 provides faculty at the Uniformed Services University with tax-deferred annuities. The University must offer tax-deferred annuities as part of its salary and benefit package to be comparable with other health professions schools in the District of Columbia vicinity and throughout the country.

Public Law 92-426 provides, in pertinent part, that civilian members of the University's faculty and staff "shall be granted retirement and other related benefits . . . so as to place the employees of the University on a comparable basis with employees of fully accredited schools of the health professions within the vicinity of the District of Columbia."

Tax-deferred annuities were approved by the Department of Defense, and faculty were recruited with the expectation of this benefit.

The Internal Revenue Service has refused to approve this benefit. They have ruled that the University, as an agency or instrumentality of the Federal government, is not eligible for a tax-sheltered annuity program under Section 403(b) of the Internal Revenue Code. This is because the University is not an agency or instrumentality of a state or a 501(c)(3) organization.

In 1960 the Internal Revenue Service ruled that tax-deferred annuities were not available to state institutions. In 1961 Congress speedily amended Section 403(b) to avoid the effect of the Service ruling. The Senate report noted the Service position was unreasonable.

One of the principal Congressional authors of P.L. 92-426 has written to the University's former President stating that tax-deferred annuities were intended by the above quoted language.

The proposed legislation does not involve tax-exemption but tax postponement. The University's failure to provide this benefit influences recruiting and retention of faculty. The Regents support the legislation as necessary to the University's continued development.

STATEMENT

Mr. Chairman and members of the Committee, the Board of Regents of the Uniformed Services University of the Health Sciences appreciates the opportunity to present its views on H.R. 6039 which would provide University faculty the benefits of tax-deferred annuities enjoyed by their colleagues at comparable schools.

The University was established in 1972 pursuant to P.L. 92-426 to train medical personnel for the uniformed services. Congress provided that a Board of Regents would conduct the business of the University.

The Board has overseen the construction of the school, from the ground breaking in July 1975. The complex of buildings has been completed, at a cost considerably less than the appropriation. This May 24th, we are graduating our first class of medical students.

The Board is also vested with the function of assembling a University faculty. The University's enabling legislation provides that: The Board . . . shall obtain the services of such . . . civilian professors . . . as may be necessary to operate the University. Civilian members of the faculty and staff shall be employed under salary schedules and *granted retirement and other related benefits* prescribed by the Secretary of Defense *so as to place the employees of the University on a comparable basis with the employees of fully accredited schools of the health professions within the vicinity of the District of Columbia.* (Italic added)

Faculty recruitment for the medical school continues. As anticipated by the Congress, we have had to be competitive with comparable medical schools in order to attract an outstanding faculty.

An important aspect of comparability is the retirement program we offer. This is especially significant in recruiting distinguished senior faculty, the people who will most affect the curriculum's effectiveness and reputation. There is one prevailing retirement plan throughout the United States (and in the vicinity of the District of Columbia) that university faculty routinely expect as part of a benefit package. A part of this is the provision for tax-deferred annuities.

On July 15, 1975, the Secretary of Defense approved a tax-deferred annuity program for civilian faculty as part of the University's retirement package. Faculty were recruited expecting this to be included in the retirement program.

On July 23, 1975, the University asked the Internal Revenue Service to issue a ruling approving favorable tax treatment. In January 1976, the Internal Revenue Service ruled that: For an employee to be entitled to participate in a tax-sheltered annuity program as described in section 403(b), the employee must either (1) be employed by a State, a political subdivision of a State or an agency or instrumentality of the foregoing and perform services for an educational institution as defined in section 501(c)(4) of the Code, or (2) be employed by an organization described in section 501(c)(3) of the Code which is exempt from taxation under section 501(a) of the Code.

Since the University apparently is an agency or instrumentality of the Federal government, and not an agency or instrumentality of a State or a political subdivision of a State, and since it apparently is not an organization described in section 501(c)(3) of the Code, we conclude that the University is not a qualified employer as described in section 403(b) and its employees are not eligible to participate in a tax-sheltered annuity program as described by that section.

The history of tax-deferred annuities at educational institutions may be of interest to the Committee.

Section 403(b) of the 1954 Code provided for tax-sheltered annuities where the annuity contract was purchased by an employer which was a tax-exempt organization described in Code Section 501(c)(3) (i.e., organized and operated exclusively for educational purposes, insofar as relevant here).

In 1955 the Internal Revenue Service ruled that an organization organized and operated exclusively for educational purposes could qualify under Section 501(c)(3) and provide the benefits of Section 403(b) tax-sheltered annuities to its employees, although it was already exempt from Federal income taxation as a wholly owned agency or instrumentality of State government. (Rev. Rul. 55-319, 1955-1 C.B. 119).

In 1960 the IRS amplified the 1955 ruling, holding that if the organization in question was being conducted under the jurisdiction of a branch or department which was an integral part of State or municipal government, the organization could not qualify as a Section 501(c)(3) organization and therefore could not offer tax-sheltered annuities. The reason was that the governmental functions of the branch or department by which it was being conducted would exceed the functions prescribed for a 501(c)(3) organization. (Rev. Rul. 60-384, 1960-2 C.B. 172).

Acting with dispatch, Congress in 1961 adopted an amendment to Code Section 403(b), designed to avoid the effect of the 1960 ruling and relieve the school supervised and conducted by a branch of department which was an integral part of State or municipal government of the necessity of qualifying as a 501(c)(3) organization before it would be entitled to the benefits of the tax-sheltered annuities in question. The reason for adopting the 1961 amendment is reflected in the Report of the Senate Committee on Finance on H.R. 4317 (Senate Report No. 379, 87th Cong., 1st Sess.). Referring to the restrictive position taken by the Internal Revenue Service in the 1960 ruling, the report stated: The Committee felt that it was not reasonable to take the view that Congress ever intended that State or local governmental units should be required to file application with the Commissioner for classification as a tax-exempt organization when the Federal Government has no power under the Constitution to tax the State or local government in the first place.

Tax-sheltered annuities under Code Section 403(b)(1)(A)(ii) are available to faculty at other medical schools, including those which are an integral part of a branch or department of State or municipal government. However, the IRS adhered to its ruling position that the program was not available to the Uniformed Services University faculty. This was in spite of a letter from a former member of Congress, who had drafted the University's legislation, indicating that tax deferral was contemplated in the legislation. This letter stated: I am unable at this time to recall exactly when the provision quoted above was first brought up. I do recall, however, that when it was, the point was made most emphatically that it was desired to make it possible for the University to offer to its faculty and staff the same type of compensation benefits including tax sheltered annuities that were available at other medical schools throughout the country; that this would be absolutely essential if the USUHS was to be in a position to compete with the other medical schools for the best professional talent. It was mentioned that even the State medical schools had these benefits by specific code provision and that the USUHS should have the same benefits.

I can assure you it was my understanding, and I am certain the other members of my committee concerned with this legislation were of the same mind, that we wanted the employees of the USUHS to have the same rights to tax sheltered annuities that were available under the Internal Revenue Code to employees of the other medical schools, including those owned and operated by a State or political subdivision thereof. I can give you the same assurance that the sentence in section 2113(f) of the statute quoted above was intended to provide those rights. It was never anticipated that the Code would be construed narrowly to exclude the USUHS employees from the benefits available to employees of virtually all other medical schools. Had that been foreseen, the statutory provision would undoubtedly have been made more precise.

It would be contrary to the Congressional intent, in my opinion, to deny these tax sheltered annuities to employees of USUHS.

I note that this is echoed in the Conference Committee Report, which states: (1) it was the general consensus of the conferees that the provisions, as written should remain deliberately broad so as to provide the Secretary of Defense and the Board of Regents, in establishing and administering the university, sufficient executive authority to ensure the kind of administrative flexibility that will be necessary to make this the finest medical school in the world in the shortest possible time.

The lack of tax-deferred annuities is an important issue to our faculty since they are being denied a benefit they would have at most other medical schools. In addition, the faculty we are recruiting express concern and are told we are attempting to provide the program. Certainly, when Congress provided this benefit to public schools in 1961, it would have included the University, had it existed. Since it did not yet exist, this bill provides a resolution of the issue.

As I'm sure you realize, the effect of this bill involves no additional budget outlay for the University and does not involve tax exemption, but tax postponement. University faculty participate in the Social Security System as well as the contributory faculty retirement plan.

During the 2nd Session of the 95th Congress, a similar bill was favorably considered by this Committee and passed by the House of Representatives. The Regents support this bill as necessary to the University's continued development, and I appreciate the opportunity to present the Regents' point of view. The Regents and I are ready to provide any further information that you and the Committee may desire.

H.R. 6140

[H.R. 6140, 96th Cong., 1st sess.]

A BILL: To prevent the abuse of certain pension plan provisions of the Internal Revenue Code of 1954 through the use of separate corporations or other organizations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 414 of the Internal Revenue Code of 1954 (relating to definitions and special rules relating to pension plans, etc.) is amended by adding at the end thereof the following new subsection:

"(m) EMPLOYEES OF ADJUNCT PROFESSIONAL ORGANIZATIONS.—

"(1) IN GENERAL.—For purposes of sections 401, 408(k), 410, 411, and 415, all employees of an adjunct professional organization, and all employees of the professional organizations which are related to such adjunct professional organization, shall be treated as employed by a single employer. With respect to a plan adopted by more than 1 such organization, the minimum funding standard of section 412, the tax imposed by section 4971, and the applicable limitations provided by section 404(a) shall be determined as if all such employers were a single employer, and allocated to each employer in accordance with regulations prescribed by the Secretary.

"(2) PREVENTION OF AVOIDANCE.—The Secretary shall prescribe such regulations as may be necessary to prevent the abuse of the provisions set forth in paragraph (1) with respect to professional organizations through the use of separate corporations, partnerships, or other organizations.

"(3) ADJUNCT PROFESSIONAL ORGANIZATION DEFINED.—For purposes of paragraph (1), the term 'adjunct professional organization' means an organization the employees of which perform services for persons who perform professional services.

"(4) PROFESSIONAL ORGANIZATION DEFINED.—For purposes of paragraph (1), the term 'professional organization' means an organization the principal business of which is the performance of professional services.

"(5) RELATIONSHIP OF ORGANIZATIONS.—For purposes of paragraph (1), a professional organization is related to an adjunct professional organization if—

"(A) the professional organization regularly uses the services of the adjunct professional organization or is regularly associated with the adjunct professional organization in performing professional services for third persons,

"(B) 1 or more of the individuals performing professional services for the professional organization (or 1 or more of the owners of such professional organization) owns an interest in the adjunct professional organization, and

"(C) 25 percent or more of the interests in the adjunct professional organization is owned by persons described in subparagraph (B).

"(6) OTHER DEFINITIONS.—For purposes of this subsection—

"(A) PROFESSIONAL SERVICES.—The term 'professional services' includes (but is not limited to) services performed by physicians, dentists, chiropractors, osteopaths, optometrists, other licensed practitioners of the healing arts, attorneys at law, public accountants, public engineers, architects, draftsmen, actuaries, psychologists, social or physical scientists, and performing artists.

"(B) ORGANIZATION DEFINED.—The term 'organization' means a corporation, partnership, or other organization.

"(C) OWNERSHIP.—In determining ownership, the principles of section 267 shall apply."

SEC. 2. (a) Except as provided in subsection (b), the amendment made by the first section of this Act shall apply to plan years ending after December 13, 1979.

In the case of a plan in existence on December 13, 1979, the amendment made by the first section of this Act shall apply to plan years beginning after December 13, 1979.

BRIEF SUMMARY—H.R. 6140

PRESENT LAW

Under present law, for purposes of testing the qualification of a pension, etc., plan, all employees of a controlled group of corporations and all employees of commonly controlled trades or businesses, whether or not incorporated, are treated as employed by a single employer. For purposes of this rule, a controlled group of corporations is determined generally by reference to the section 1563(a) definitions of parent-subsidiary controlled group and brother-sister controlled group. The commonly controlled trade or business determination is to be made under regulations which are to "be based on principles similar to the principles" which apply in the case of controlled groups of corporations.

However, corporations in a brother-sister relationship are aggregated for plan purposes only if the same five or fewer persons who are individuals, estates or trusts own, among other things, more than 50 percent of the voting power (or value) of the stock in two or more corporations, and other conditions are satisfied. Similar rules apply in the unincorporated trade or business regulations.

These rules allow individuals to avoid covering rank-and-file employees by establishing individual corporations which then form a partnership of corporations. The partnership employs the rank-and-file employees. Because neither corporation has a more than fifty percent interest in the partnership, the partnership is not a member of a group of commonly controlled trades or businesses. Therefore, the requirement or aggregation of employees for purposes of meeting the qualified plan rules does not apply. Since the aggregation rules do not apply, the plans established by the professional corporations need not provide coverage for the partnership employees.

This result has been affirmed by the Tax Court in a recent case, *Lloyd M. Garland, M.D., F.A.C.S., P.A.*, 73 T.C.—, No. 1, (1979).

EXPLANATION OF THE BILL

The bill would expand the classes of controlled groups of businesses required to be considered as a single business in testing whether a pension, etc., plan maintained by any business in the group meets the tax-qualification requirements of the Code. In particular, the bill would require aggregation for pension, etc., plan tax-qualification purposes, of professional organizations, and certain related service organizations which furnish rank-and-file type support services.

The bill would change the controlled group rules insofar as they relate to professionals by requiring the aggregation, for qualified plan purposes, of a professional organization and any "adjunct professional organization" if (1) the professional organization regularly uses the services of, or is regularly associated in performing services with, the adjunct professional organization, (2) one or more of the professionals (or the owners of the professional organization) owns an interest in the adjunct organization, and (3) such individuals, as a group, own at least 25 percent of the adjunct organization. (The attribution rules of Code section 267, relating to transactions between related taxpayers, apply in determining ownership.) An adjunct professional organization is defined as an organization where the employees perform services for persons who perform professional services.

The bill limits its aggregation rules to situations where professional services are provided. For this purpose, professional services include services performed by physicians, dentists, chiropractors, osteopaths, optometrists, other licensed practitioners of the healing arts, attorneys at law, public accountants, public engineers, architects, draftsmen, actuaries, psychologists, social or physical scientists, and performing artists.

EFFECTIVE DATE

Generally, the provisions of the bill would apply to plan years ending after December 13, 1979. In the case of a plan in existence on December 13, 1979, the bill would apply to plan years beginning after that date.

REVENUE EFFECT

It is estimated that this bill would increase budget receipts from the income tax by up to \$50 million in fiscal year 1980 and by substantially larger amounts in the later years. In addition, the bill would eventually increase budget receipts from estate tax by significant amounts.

SAN DIEGO, CALIF., April 9, 1980.

SELECT REVENUE MEASURES SUBCOMMITTEE,
Longworth House Office Building,
Washington, D.C.

GENTLEMEN: The purpose of this letter is to submit written testimony for the hearing record to be held on April 17, 1980, concerning HR 6140, which is intended to prevent the abuse of certain pension plan provisions of the Tax Code through the use of separate corporations or other organizations.

HR 6140 in its present form will prevent the abuse of certain pension plan provisions through the use of separate corporations, but will also cause confusion and complications in certain situations where professional organizations have no intention of discriminating against rank and file employees.

I would like to give you an example of a situation in which the professionals have no desire to discriminate but the bill in its present form creates ambiguities as to how to solve the apparent problems. A corporation or partnership is owned by 10 different physicians. This business is referred to as the "Billing Business." The Billing Business employs all the rank and file employees and collects all the revenue from professional services. Each of the 10 physicians who own a share of the Billing Business are incorporated, and most of them have one or more pension plans. The Billing Business has adopted a Money Purchase Pension Plan which calls for a mandatory contribution by the business of 25 percent of compensation of the eligible participants. The plan has eligibility provisions and a vesting schedule which is identical or more favorable than any of the pension plans maintained by the professional corporations. Some of the professional corporations maintained defined benefit plans.

The apparent problem in the above example is how are the professional corporations to cover the rank and file employees of the Billing Business in their pension plans if the rank and file employees are already receiving 25 percent of their compensation via the Money Purchase Pension Plan of the Billing Business. It would appear that the proper result should be that the rank and file employees who are to be participants in each professional corporation's Defined Benefit Plan would be limited to a benefit which would not violate § 415(e) of the Internal Revenue Code which deals with the limitation on benefits in the case of a Defined Benefit Plan and a Defined Contribution Plan for the same employee. By way of further example, if one of the professional corporations maintained a 25 percent Money Purchase Pension Plan, the rank and file employee would receive no benefits under the professional corporation's plan since the employee has reached the limitation for defined contribution plans via the Billing Business pursuant to § 415(c) of the Internal Revenue Code.

In the above example where the professional corporation maintain defined benefit plans, the Internal Revenue Service may disqualify the defined benefit plans because they are not comparable with money purchase pension plans. See Rev. Ruls. 66-12, 66-13, 66-14, and 66-15, 1966-1 C.B. 72, 73, 75 and 83. I do not believe that the disqualification of the defined benefit plans is justified provided that the rank and file employees are receiving the maximum annual limitation under §§ 415(c) and (e) of the Internal Revenue Code under one or more plans.

The Internal Revenue Service may argue that an employee would receive greater benefits if he or she were covered under the defined benefit plans of the professional corporations exclusively rather than under the money purchase pension plan of the Billing Business. This may or may not be true, depending upon the age and compensation of the rank and file employees. For example, a rank and file employee, who is 25 years old, would clearly in virtually every case be better off in a 25 percent money purchase pension plan than any defined benefit plan.

There are good business reasons for different types of pension plans for professional and their employees. Many professionals incorporate separately in order to tailor their retirement plans for their own needs. I see no conceptual problem with this desire. It would be fair and practical if the Billing Business could continue to cover rank and file employees provided each participant receives the maximum annual addition under § 415(c) and (e). In other words, this would be a fail-safe provision.

If the professional corporations maintain defined benefit plans, to avoid covering the rank and file in their plans, the Billing Business would have to establish a defined benefit plan so that the participants would reach the maximum limitation under § 415(e). If this were a fail-safe provision, then the confusion and complications of including each rank and file employee in ten different pension plans could be avoided. I think that this is an equitable solution to a very complicated problem.

The purpose of HR 6140 is to prevent abuse by professionals, but it should not be drafted in such a way that would produce duplication of benefits to rank and file employees. The problem in the above example could be solved by regulations to be issued by the Secretary of the Treasury, but I believe it would be preferable for Congress to make specific reference to the problem in its solution in order to provide immediate guidance to professionals.

Very truly yours,

LAWRENCE S. BRANTON.

SPRINGFIELD, VA., April 11, 1980.

HON. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. ROSTENKOWSKI: My name is Britta DeMello. I am employed as a secretary at a law office here in Washington, D.C. I would be grateful if my written testimony in connection with H.R. 6140 could be included for consideration by your Subcommittee.

The firm has a qualified retirement plan which meets the requirements of ERISA and the firm wishes to keep the plan in that status. The question was raised: May employees be permitted to opt out of the plan? The firm passed the question on to the IRS and I was informed by the Administrator of the firm that the IRS has decided that only associated attorneys, on the basis that they qualify as "highly paid executives" may be permitted to opt out. I am informed that the IRS has informed the firm that to permit other persons to opt out would be considered discriminatory, and, therefore, would not be within the provisions of ERISA.

On my behalf the Honorable Herbert Harris raised the issue with the Commissioner of Internal Revenue. In response the IRS referred to § 401(a)(4) of the Code which "requires that contributions or benefits in a qualified retirement plan may not discriminate in favor (emphasis added) of employees who are officers, shareholders or highly compensated. Since discrimination cannot be in favor of these prohibited group members, the fact that these individuals may elect out of the plan does not result in discrimination in their favor under the plan." The IRS letter (copy attached) goes on to explain that "the Code provisions do not preclude an employer from requiring such participation as a condition of employment."

The net result of this ruling is that the law permits the firm to allow attorneys to opt out of the ERISA plan and at the same time allows the firm to require other employees to remain in the plan. Therefore, attorneys who are paid more get a tax advantage that is denied to lower paid employees. Because they were permitted out of the employer's retirement plan, they are free to invest in an independent savings plan, which is tax exempt at this time. By the same ruling, we, lesser paid employees, are not permitted to have an independent retirement plan, and thus are denied the option of a \$1,500 tax break. Yet, the intention of the ruling would appear to be non-discrimination in favor of highly compensated officers.

I respectfully request that your Committee consider an adjustment in the legislation on which this ruling is based, so that this minor, but important, inequity may be corrected.

Thank you for the opportunity to present my views.

Sincerely,

(MRS.) BRITTA DEMELLO.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., February 6, 1980.

HON. HERBERT E. HARRIS II,
House of Representatives,
Washington, D.C.

DEAR MR. HARRIS: This is in response to your recent letter to Commissioner Jerome Kurtz which was forwarded to this office for consideration and reply. Enclosed with your letter was correspondence from Mrs. Britta DeMello from Springfield, Virginia.

Mrs. DeMello states in her letter that she is employed by a law firm which maintains a qualified employee retirement plan. The plan administrator informed her that only associated attorneys can be allowed to "opt out" of the plan because (1) they are not considered long-term employees and (2) they are classified as "highly paid executives."

You wish to know if there is a ruling which covers this situation and whether the Internal Revenue Service is contemplating a ruling which would allow any employee to be excluded from plan participation if he or she so desires.

A member of my staff spoke with a representative of your office concerning Mrs. DeMello's statement that attorneys are short-term employees and, therefore, excludable from plan participation. It was explained that there is no such provision under the Internal Revenue Code. However, the fact that such attorneys are classified as highly compensated employees can be a basis on which to allow them to be excluded from plan participation.

Section 401(a)(4) of the Code requires that contributions or benefits in a qualified retirement plan may not discriminate in favor (Emphasis added) of employees who are officers, shareholders or highly compensated. Since discrimination cannot be in favor of these prohibited group members, the fact that these individuals may elect out of the plan does not result in discrimination in their favor under the plan.

The requirements for qualified plans under the Internal Revenue Code do not expressly discuss whether an employer may require his employees to participate in his plan. However, the Code provisions do not preclude an employer from requiring such participation as a condition of employment. An employer may wish to do this in order to insure that the plan satisfies the coverage requirements of section 410(b) of the Code.

The Internal Revenue Service does not have the authority to act on Mrs. DeMello's suggestion that every employee be allowed to opt out of his company's retirement plan since our function is limited to administration of the tax laws which are enacted by Congress. The change recommended by Mrs. DeMello would require legislative action.

Furthermore, it should be noted that section 1509 of the Tax Reform Act of 1976 directs the Joint Committee on Taxation to conduct a study regarding the expansion of participation in individual retirement accounts (IRA's) to active participants in qualified retirement plans. In addition, various legislative proposals aimed at permitting at least limited IRA participation for participants in qualified plans have been introduced. To date, however, none of these bills have been enacted into legislation.

We hope this information will be of assistance to you in replying to Mrs. DeMello.

Sincerely yours,

JAMES J. FEEHAN, Jr.,
Acting Chief, Employee Plans, Technical Branch.

EARL HALL, CHARTERED,
Lewiston, Idaho, April 16, 1980.

JOHN M. MARTIN, Jr.,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building,
Washington, D.C.

DEAR MR. MARTIN: Please have the Subcommittee on Select Revenue Measures consider the following and include in the printed record of the hearing on H.R. 6140 to be held April 17, 1980.

As background, this corporation is a professional corporation which has joined with other individuals and a corporation in a partnership to practice public accounting. The corporation, directly and by rules of attribution, has a 22% capital and profits interest in the partnership.

The partnership has a Keogh plan providing the maximum benefit permissible in a defined contribution Keogh plan.

If this bill is enacted, this corporation would be required to include partnership employees in any plan it adopts to the extent that any required contribution under the corporate plan would exceed 15% of employees compensation.

Whether or not the bill is enacted, individuals as partners could not contribute more than 15% of employees compensation to their Keogh plans.

Thus, while the bill could potentially increase the costs to this corporation of any corporate retirement plan it adopted, it could also give this corporation (or any other corporation which is a partner in the partnership) leverage over non-corporate partners for employee loyalty, motivation, or other purposes of establishing a retirement plan.

Garland, 73 TC No. 2, and *Kiddie*, 69 TC 1055, provide good law because they recognize that there is a difference between controlling and noncontrolling partners.

As H.R. 6140 seeks to overturn *Garland*, it would legislatively eliminate such distinction.

Section 269 currently prevents corporations from being formed to avoid income tax by setting up corporate plans to get a deduction not otherwise available without covering partnership employees. This was not argued in *Garland* and *Kiddie* and therefore is assumed not to be the situation in those cases.

In summary, H.R. 6140 is poor law, drafted to close a loophole which is already closed by an existing section of the code, and would add to an already complex and swollen tax law.

Yours very truly,

EARL HALL, *President.*

PIEDMONT, CALIF., December 27, 1979.

Representative DAN ROSTENKOWSKI,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: I read your proposed Bill H.R. 6140 with interest, since I was considering incorporating myself as a professional corporation. I am a partner in a law partnership having 16 partners and approximately 80 other employees. For various reasons, a consensus within the firm does not exist for incorporating. I was considering incorporating individually due to the \$7,500 limitation placed on Keogh Plan contributions. Because I am a partner in a law partnership rather than a shareholder in a law corporation, I am discriminated against in the amount I can contribute to a retirement program. In addition, the employees of our partnership are discriminated against since there is no incentive for the partners to increase the Keogh Plan percentage contribution in view of the \$7,500 limitation.

I have been unable to discover a satisfactory explanation why partnerships and their employees are discriminated against in favor of corporations and their employees and I would be interested in knowing if there is a legitimate explanation for such disparate treatment. If there is none, I would suggest and urge that concurrently with proposing your present bill you also propose that the \$7,500 limitation on Keogh Plans be removed. At the minimum, this limitation should be adjusted upwards to reflect the increased cost of living and inflation.

Very truly yours,

VICTOR J. HAYDEL III.

ALBANY, N.Y., April 21, 1980.

JOHN M. MARTIN, JR.,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building,
Washington, D.C.

DEAR MR. MARTIN: As one who has actively practiced in the professional corporation area for a number of years, I would like to offer my comments on the above referenced bill.

I think most practitioners will agree that the *Kiddie* and *Garland* cases, although correctly decided, do permit an "abuse situation" which must be corrected. However, for the reasons set forth in a New York State Tax Section's report on the bill, I do not believe the present legislation provides the correct, or complete answer to the problem.

It is interesting to see how quickly legislation can be prepared and introduced where the Treasury, or Ways and Means staff, determines that a problem favor-

ing the professional exists. On the other hand, where an equally "abusive" situation exists to the detriment of the professional, no action seems to be taken.

I am, of course, referring to ERISA's "solution" to the "service" corporation problem via the use of the controlled corporation concept. While the controlled corporation approach may be appropriate (notwithstanding *Fairfax Auto* and subsequent decisions) when dealing with surtax exemptions, it obviously was ill-suited for any application in the pension area. The *Garland* case was a clear example of this in a situation which favors a prohibited class. However, there have been many situations in which the controlled corporation (controlled entity) concept has created undue (and hopefully unintended) hardships, and these are equally deserving of your Committee's attention. The following examples are just indicative of the problems that the controlled corporation concept, as applied to the pension area, has created:

Example 1: A doctor (whether incorporated or a sole proprietor) has practiced many years, having a Keogh or corporate retirement plan covering all employees who provide service in the medical practice. The doctor also has a 55 percent interest in a nursing home, with the balance of the nursing home interest owned by an unrelated third party. Under state law, the nursing home must be maintained as a separate business, and neither the medical practice nor the nursing home can be operated as a single entity. Under the controlled corporation concept, the doctor must disband his Keogh plan or corporate retirement plan unless the employees of the nursing home are covered under a comparable retirement plan.

Example 2: Assume the same facts as Example 1, but the doctor has a 55 percent interest in a lumber mill or other separate business, perhaps located in another state or states. The same results ensue despite the fact that the "abuse situation" which Section 414 was intended to correct is not present.

Example 3: Assume the same facts as in Example 1, but the doctor has no ownership interest in any other business. However, the doctor's wife runs a boutique, and the doctor has served as a member of the Board of Directors of the wife's corporation for a number of years. The doctor must either resign as a Director and sever all other business connections with the wife's business or both businesses must provide retirement benefits which are comparable.

The problems demonstrated by the above examples all result from the mechanical application of a statutory concept which was not designed for the purpose for which it is presently used. While the solution may have been a "handy" one back in 1974, it was ill-advised then and continues to be ill-advised at this time.

The crux of the problem is the creation of separate business entities for the purpose of avoiding coverage of common-law employees under a plan which provides benefits for the "prohibited" class member. The law, therefore, could adopt this more general approach, perhaps with the elimination of any mechanical criteria. Simply put, if the business activities could have been conveniently carried on under a single banner, but are carried on under separate banners, either solely or partially for the purpose of avoiding pension coverage for common-law employees, then all employees shall be aggregated.

It is true that this approach will place some additional burden on the Internal Revenue Service, but it is far better to place the burden on the Service than to develop and enforce an inequitable statute. Furthermore, the Service has never been reluctant to "side-step" such burdens (e.g., §§ 269, 482, etc.) when it is to the Service's benefit.

I should also point out that the Service fought long and hard for residual authority to disqualify plans where a vesting schedule discriminates in operation. The proposed regulations on this subject, which have just been released, probably go beyond Congressional intent in the area, but at the very least demonstrate that the Service is willing to exercise discretion to prevent what it deems an abuse. In this regard, I am enclosing a letter to the Service on this subject, which you may find of interest.

I have no patience with a professional, or any other employer, who attempts to exclude legitimate employees from the benefits of fringe benefit programs. On the other hand, I look with equal disdain upon those who utilize an ill-designed "club" to regulate a specific problem, and then move with dispatch to cure the effects of the use of such "club" only when the interest of government appear to be thwarted.

Sincerely,

ROBERT E. HELM.

ALBANY, N.Y. April 21, 1940.

Re proposed vesting regulations.

COMMISSIONER OF THE INTERNAL REVENUE SERVICE,
Washington, D.C.

GENTLEMEN: I have read with some dismay the proposed regulations regarding discrimination in operation with respect to vesting schedules.

As a practical matter, the proposed regulations will "force" all small employers to adopt the "700" safe harbor vesting schedule, since the effect of the regulations almost certainly will cause district offices to disqualify plans which do not comply with this rule.

As a practical matter, many small employers, especially professional corporations, experience a high-turnover rate among the common-law employees. This is also true of many small nonprofessional employers and the reasons stem more from the transient nature of our population, the age groups seeking employment with such employers, etc. than with any particular employer policies. Indeed, most of these employers (including myself) seek long-service employees, and do everything within their power to eliminate this turnover problem.

The difficulty with the proposed regulations is that they lose sight of the fundamental purpose of a qualified retirement plan, i.e., to provide retirement benefits for employees. The purpose of such plan is not to provide enriched severance benefits, or to encourage termination of employment.

The proposed "700" safe harbor test, simply put, provides enriched termination benefits for short-lived employees as the price to be paid for assuring that one's plan will not be attacked for discrimination in operation. Worse yet, it will force the small employer to adopt a schedule meeting the test, since the bureaucratic "interpretive" fall-out will almost certainly result in many small plans losing their qualified status.

The regulations are also disappointing in that they provide no meaningful guide for determining what constitutes discrimination in operation once the safe harbor rule is not available. We have all known for years that one compares the vested interest of common-law vs. prohibited class employees, turnover rates, etc. However, it is obvious that the prohibited class almost certainly will have greater vested interests in small employer plans, and the question is when such disparity in vested interest will result in disqualification. For example, if all prohibited class employees have a 100 percent vested interest in a "4-40" schedule, and only one of five common-law employees have achieved a 40 percent vested interest, will the plan be disqualified. In our own retirement plan, we provide a 40 percent vested interest after 4 years, 60 percent after 5 years, 80 percent after 6 years and 100 percent after 7 years. While three prohibited class members have 100 percent, 100 percent and 80 percent vested interests respectively, in their account balances, only 1 other common law employee is covered, and she has attained a 40 percent vested interest. The remaining 4 common-law employees have just completed 1 year of service and will enter the plan this year. Will not the effect of the proposed regulations be to disqualify our plan as being "discriminatory" in operation? If so, why should this be so, especially since pregnancy was the prime reason for turnover and the employees receive disability benefits?

In summary, the basic flaw in the proposed regulations is that they "force" pension plans to be severance pay plans in the small corporation, while they leave the larger corporation relatively unscathed. Furthermore, they fail to provide any meaningful criteria or test for determining discrimination in operation when a plan fails to meet a safe harbor rule, and this will simply force smaller employers to adopt the "700" approach or risk a finding of discrimination in operation by an over-exuberant district office.

Sincerely,

HELM, SHAPIRO, AYERS,
ARNT & ALDRICH, P.C.
BY: ROBERT E. HELM.

STATEMENT OF NATIONAL LIFE OF VERMONT, WILLIAM L. CASSIDY, VICE PRESIDENT,
PENSION DEPARTMENT

National Life Insurance Company has been active in the pension field for over 25 years.

During this period, we have not only provided insurance and annuity contracts used in the funding of pension and profit-sharing plans, but have assisted in the administration of such plans, including cost calculations.

At the present time, more than 2000 plans have been adopted which use one of the nine prototype plans which we sponsor, and we are under contract to provide administrative services to approximately 500 plans.

We recognize the area of perceived abuse to which H.R. 6140 is addressed, as exemplified by the Tax Court decisions in the *Kiddie* and *Garland* cases. Nevertheless, if abuse is possible under present law, any corrective legislation should address the root of the problem, not individual branches. In other words, the abuse should be prevented in all instances—not only when it is practiced by the particular type of organization in these two cases, viz., professional corporations or associations.

The Internal Revenue Service, in both of these cases, relied on their long-standing position on joint ventures as expressed in Revenue Ruling 68-370, but I call your attention to the fact that this Ruling considered two corporations which were involved in the construction business.

Neither does it seem logical that treatment as a member of a controlled group should be triggered for a professional organization (or for any other type of organization) by the outside ownership interests of an employee who possesses no ownership interest in the employer.

A preferable approach might be to amend section 414(b) of the Internal Revenue Code, to provide that the test for the existence of a controlled group found under section 1563(a)(2)(B) be changed somewhat whenever there is some substantive element of identical ownership between a corporation and another organization which provides services to that corporation. When such a service relationship exists, instead of considering only identical ownership, the ownership of a person could be reflected to the extent of that person's greatest ownership whenever the identical ownership exceeds some minimum, such as 16 percent.

This could be accomplished by adding the following, or a similar, sentence to section 414(b):

In the case of an organization which provides services to one or more corporations, the portion of section 1563(a)(2)(B) which provides that the stock ownership of each person shall be taken into account only to the extent that such ownership is identical with respect to each organization shall be disregarded in the case of any person who owns at least 16 percent of both a corporation and its service organization and, instead, the ownership of that person shall be taken into account to the extent of the greater ownership held with respect to those organizations.

Such a provision would avoid the presumably unintended results which would be obtained under the proposed legislation in the following fact situation:

Suppose a large accounting firm, which provides a retirement plan for its employees, regularly uses the services of a commercial window washing concern. Further suppose that the wife of an accountant employed by the accounting firm, but who possesses no ownership interest in that firm, inherits 50 percent interest in the window washing concern from her father.

Under the proposed legislation, the employees of the accounting firm and those of the window washing concern are suddenly treated as employed by a single employer for pension purposes.

Please see Appendix A, prepared by Charlotte Lane, E.A., of our staff, for charts which compare the results (for pension purposes) of present law, of the proposed legislation and of this alternative proposal, under five other fact situations, all of which involve unrelated individuals. In Appendix B, you will find these results analyzed.

The alternative approach suggested seems to prevent the discrimination felt by the Internal Revenue Service to exist in the *Kiddie* and *Garland* situations, (regardless of the type of business in which the corporation may be engaged), without unduly hampering less manipulative organizational arrangements, and I ask that you give it serious consideration.

APPENDIX A

COMPARISON OF RESULTS IN 3 FACT SITUATIONS

(Prepared by Charlotte Lane, E.A., Pension Research Consultant)

[In percent]

	Ownership in—		
	Corporation A	Corporation B	Partnership ¹
By individual:			
A.....	100		80
B.....		100	80

¹ The partnership provides services to the 2 corporations.

1. Under present law, no controlled groups are represented above.
 2. Under proposed legislation, if—but only if—Corporation A and/or Corporation B were professional organizations, the employees of the partnership and those of the corporation would be considered to be employed by 1 employer. Would A and B be under common control?

3. Under our alternative proposal, Corporation A and the partnership would be considered as under common control, regardless of the type of business in which the corporation is engaged. The same would be true of Corporation B and the partnership, but Corporation A and Corporation B would not be under common control.

[In percent]

	Ownership in—			
	Corporation A	Corporation B	Corporation C	Partnership ¹
By individual:				
A.....	100			
B.....		80		
C.....			80	20
D.....		20		25
E.....				55
F.....			20	

¹ The partnership provides services to all 3 corporations, all of which are professional organizations. Individual D is an employee of Corporation A who provides professional services. Individual E is an employee of Corporation C, but does not himself provide professional services.

1. Under present law, no controlled groups are represented above.
 2. Under proposed legislation, the employees of the partnership and Corp. A are considered to be employed by 1 employer. This is also true of the partnership and Corp. B, but is not true of the partnership and Corp. C.

3. Under our proposed alternative, only the partnership and Corp. C would be under common control.

[In percent]

	Ownership in—		
	Corporation A	Corporation B	Corporation C ¹
By individual:			
A.....	20	15	16
B.....	20	15	16
C.....	20	15	16
D.....	20	15	16
E.....	20	15	16
F.....		5	
4 others.....		25	15

¹ Corporation C provides services for both Corporation A and Corporation B.
² Each.

1. Under present law, only Corp. A and Corp. C are under common control.
2. Under proposed legislation, if—but only if—Corp. B were a professional organization, the employees of Corp. B and Corp. C would also be considered to be employed by 1 employer.
3. Under our alternative proposal, the results would be the same as under present law.

(In percent)

	Ownership in—					
	Corporation A	Corporation B	Corporation C	Corporation D	Corporation E	Partnership ¹
By individual:						
A	100					20
B		100				20
C			100			20
D				100		20
E					100	20

¹ The partnership provides services to each corporation.

1. Under present law, no controlled groups are represented above.
2. Under proposed legislation, the results are the same.
3. Under our proposed alternative, the partnership would be considered under common control with each corporation.

(In percent)

	Ownership in—		
	Corporation A	Corporation C	Partnership ¹
By individual:			
A	50	25	20
B		25	
C	50	50	5
D			75

¹ The partnership provides services to both Corporation A and Corporation C, which are both professional organizations.

1. Under present law, although Corp. A and Corp. C are under common control, there is no common control with the partnership.
2. Under proposed legislation, not only are Corp. A and Corp. C under common control, but the employees of the partnership and the employees of each corporation would also be considered to be employed by 1 employer.
3. Under our alternative proposal, Corp. A and Corp. C are under common control, and so are Corp. A and the partnership, but Corp. C and the partnership are not.

APPENDIX B

ANALYSIS OF RESULTS IN 5 FACT SITUATIONS

I. This situation is representative of the Kiddie and Garland cases.

Both the proposed legislation and our alternative proposal would correct the abuse perceived by the IRS in such cases if the corporations involved were professional organizations.

The proposed legislation would have no effect on a similar situation involving nonprofessional organizations. Our alternative proposal would treat all such relationships identically.

II. The proposed legislation would, in the case of Corporation A and the partnership, reach the equivalent of a controlled group situation by way of the outside ownership interests of an employee who possesses no ownership of the employer. This would require the illogical inclusion that Corporation A would either have to include in its pension plan, the employees of one of their employees, or dispense with the services of that employee.

In the case of Corporation B and the partnership, the proposed legislation would reach the equivalent of a controlled group situation through the owner-

ship interest of Individual D, despite the fact that he has no effective ownership control of either the corporation or the partnership.

Under our alternative proposal, the unfair results described in the two preceding paragraphs would be avoided, but common control would be found between Corporation C and the partnership, even though it would not under the proposed legislation.

This seems a reasonable result since Individual C not only has actual control of Corporation C, but also has an interest in the partnership greater than the 16 percent which (on the basis of equal control) would be sufficient for 5 or fewer persons to possess the 80 percent control necessary for a controlled group situation to exist under IRC 1563(a)(2).

III. Under the proposed legislation, the equivalent of common control would be found between Corporation B and Corporation C, if Corporation B were a professional organization, even though the basic requirement for common control under present law is missing. This is the requirements of IRC 1563(a)(2), mentioned above, that the same 5 or fewer persons own at least 80 percent of each organization.

Our alternative proposal would not expand upon established law in this respect.

IV. The proposed legislation would offer no improvement over present law in situations similar to that in Kiddie and Garland whenever at least 5 equal partners could be assembled.

Under our alternative proposal, there would be a controlled group situation whenever the 5 or fewer persons/80 percent ownership rule (cited above) is met in connection with a number of wholly owned corporations using the services of another jointly owned organization.

V. Under both the proposed legislation and our alternative proposal, Corporation A and the partnership would be treated as under common control even though they would not be under present law. This seems reasonable, since Individuals A and C have both complete ownership of Corporation A and a minority interest in the partnership.

Under the proposed legislation, however, Corporation C and the partnership would also be considered as though under common control, while under our alternative proposal they would not.

This result of our alternative proposal would seem reasonable to us because of the existence of Individual B. Individual B has a 25-percent interest in Corporation C (an ownership equal to that of Individual A), but no interest at all in the partnership, and is, therefore, in a position to act as a check upon the more manipulative possibilities in the relationship between Corporation C and the partnership.

H.R. 6247

[H.R. 6247, 96th Cong., 2d sess.]

A BILL To amend the Internal Revenue Code of 1954 to provide that in certain cases where married individuals live apart community property laws will not apply for Federal tax purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF COMMUNITY INCOME WHERE SPOUSES LIVE APART.

(a) GENERAL RULE.—Part I of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (defining gross income, adjusted gross income, taxable income, etc.) is amended by adding at the end thereof the following new section:

"SEC. 66. TREATMENT OF COMMUNITY INCOME WHERE SPOUSES LIVE APART.

"(a) GENERAL RULE.—If—

"(1) 2 individuals are married to each other at any time during a calendar

year;

"(2) such individuals—

"(A) live apart at all times during the calendar year, and

"(B) do not file a joint return under section 6013 with each other for a taxable year beginning or ending in the calendar year;

"(3) such individuals have earned income for the calendar year which is community income; and

"(4) no portion of such earned income is transferred (directly or indirectly) between such individuals before the close of the calendar year; then, for purposes of this title, any community income of such individuals for the calendar year shall be treated in accordance with the rules provided in section 879(a).

"(b) DEFINITIONS.—For purposes of this section—

"(1) EARNED INCOME.—The term 'earned income' has the meaning given to such term by section 911(b).

"(2) COMMUNITY INCOME.—The term 'community income' means income which, under applicable community property laws, is treated as community income.

"(3) COMMUNITY PROPERTY LAWS.—The term 'community property laws' means the community property laws of a State, a foreign country, or a possession of the United States."

(b) CLERICAL AMENDMENT.—The table of sections for part I of subchapter B of chapter 1 of such Code is amended by adding at the end thereof the following new item:

"Sec. 66. Treatment of community income where spouses live apart."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to calendar years beginning after December 31, 1979.

BRIEF SUMMARY—H.R. 6247

PRESENT LAW

Under present law, income considered community property under State law generally is taxed in equal shares to a husband and wife. Consequently, if a husband and wife file separate returns, each is required to report one-half of the community income. Generally, no special exception is made to this treatment for spouses who live apart. In certain cases, an abandoned spouse may have to report a share of the community income earned by the other spouse although the abandoned spouse has not actually received any of the income.

EXPLANATION OF THE BILL

If certain requirements are met, the bill would disregard State community property laws with respect to certain types of income for Federal income tax purposes. For purposes of the bill, a couple must be married at some time during the calendar year, but live apart during the entire calendar year and not file a joint return with respect to a taxable year beginning or ending in the calendar year. In addition, the spouses must have earned income for the calendar year that is community income, and no portion of that earned income must have been transferred directly or indirectly between the spouses during the calendar year.

If the requirements are met, any community income of the spouses for the calendar year would be allocated in accordance with Code section 879(a). In particular, that section provides that, generally, earned income is, for tax purposes, the income of the spouse who rendered the personal services.

EFFECTIVE DATE

The provisions of the bill would apply to calendar years beginning after December 31, 1979.

REVENUE EFFECT

It is estimated that this bill would have a negligible effect on budget receipts.

STATEMENT OF PROF. STUART J. FILLER, UNIVERSITY OF BRIDGEPORT SCHOOL OF LAW

INTRODUCTION

My name is Stuart J. Filler, and I reside at Bradley Lane, Sandy Hook, Connecticut 06482. Presently, I am a Professor of Law and Director of Clinical Programs at the University of Bridgeport School of Law, 600 University Avenue, Bridgeport, Connecticut 06602. In addition, I am the faculty supervisor of the Law School's Tax Clinic. Prior to joining the faculty at the University of Bridgeport School of Law, I was a member of the faculty at Hofstra University School of Law for over six years. Prior to joining the faculty at Hofstra University School of Law, I was employed by the Legislative and Regulations Division of the Office of Chief Counsel of the Internal Revenue Service in Washington, D.C. I received B.B.A. and M.B.A. degrees from the University of Michigan and a J.D. degree from New York University School of Law.

I appear before this Committee in my individual capacity. Nothing I will say is intended to represent the view of the University of Bridgeport. Furthermore, I am not appearing at the request of any client, nor do I presently represent a client who would benefit in any significant way from my proposals.

To begin with, I would like to assure you that any noncomplimentary comment I make about the Internal Revenue Service or any employee thereof or about the Congress or any member thereof is made in a constructive spirit that is intended to improve the system, and not in a vindictive spirit to damage it. For the most part, I have found the civil servants at the Internal Revenue Service to be highly motivated individuals with a sincere desire to collect only what is in their perception the correct amount of tax liability for any taxpayer.

SUMMARY OF PRESENTATION

I recommend that we return to a pre-1948 single tax rate schedule for all taxpayers without regard to any marital or other status. In doing so, I recommend that Congress adopt a federal income tax rule allocating earned income to the person who actually earned it and capital income in relation to the contribution of each person to the purchase of the property, without regard to any state property law allocation to the contrary.

There are many other individuals with similar positions, and I have concentrated my testimony on the problem concerning the joint and several liability imposed on both spouses when a joint return is filed and on the problem of allocation of income to both spouses in a community property state after the spouses have separated but prior to divorce. It is not uncommon for this separation period to extend for many years.

HISTORY OF TAX DISCRIMINATION BASED ON MARITAL STATUS¹

When the Revenue Act of 1913 was enacted, there was only one rate schedule. The individual was the sole taxable entity and each taxpayer was taxed on his or her own earned income. Because the rate structure was progressive, taxpayers with large incomes attempted to shift their income, particularly unearned but also earned, to other family members to report the income on each taxpayer's individual tax return. This device enabled the family not only to split income but also to increase deductions, thereby subjecting total family income to lower federal income taxes than it would have been subjected to if only one individual tax return were filed with the entire family income.

Much of the controversy concerning the validity of these shifts stemmed from the variation in treatment of marital property by different states. Most states predicated ownership on taking an active role in acquiring income or property. Eight southern and western states, however, had marital property laws based on the community property system, which gave each spouse a half share of any property or income acquired by either spouse after marriage.

The Department of the Treasury acquiesced in the states' determination of title to income for federal income tax purposes. In 1921, the Attorney General determined that husbands and wives could each report half of all community property income on individual tax returns in all community property states in which a spouse's interest vested when the income was earned. Attempts by taxpayers in non-community property states to achieve a similar effect through contractual arrangements were disapproved by the United States Supreme Court in *Lucas v. Earl*, 281 U.S. 111 (1933).

Since no state laws allowed income-splitting between spouses in non-community property states, the tax treatment of married taxpayers living in community property states differed from that of taxpayers earning the same income in non-community property states. This discrimination was not terribly burdensome, however, because of the low tax rates at the time.

The low federal income tax rates did not produce enough income to offset the expenditures brought about by the Depression and World War II. The tax base was enlarged and tax rates were increased. This change made the advantages to married taxpayers in community property states both significant and conspicuous. Consequently, several non-community property states enacted community property laws. The prospect of more states making the same switch prompted action by Congress in 1948.

The need for action culminated in the first session of the Eightieth Congress. Despite recognition that it was not a complete solution to the unequal taxation problems, the split income plan was chosen by Congress as the method for achieving geographic uniformity in taxation of married couples. In 1947, income-splitting amendments were added to two tax reduction bills. Finally, this became the Revenue Act of 1948, Sec. 301, 53 Stat. 5, 17.

Soon after this bill was passed, Congress began to doubt whether this solution was fair to taxpayers who could not take advantage of its provisions. Congress made a series of rate concessions to reduce the advantages of income-splitting. These reductions confirmed the failure of the 1948 plan to provide equality of tax treatment to all taxpayers without regard to their marital status.

In 1951, Congress began to mitigate the inequities of income-splitting by establishing a special category of taxpayers called "heads of household" and allowing single taxpayers who maintained a home for both themselves and a dependent to pay taxes at a new rate rather than at the high singles' rate. This new rate was halfway between the married and single rate. This new rate was expanded in 1954 to allow single persons who maintained a parent in a separate home to take advantage of the reduced rates. In addition, a new "surviving spouse" category was added which allowed income-splitting joint return rates for two years after the year in which certain taxpayer's spouse died.

In 1969, Congress responded to public pressure calling for tax relief for singles by enacting a new reduced single taxpayer rate schedule as part of the Tax Reform Act of 1969. Despite testimony revealing that two-earner married couples bore at least as much of an inequitable tax burden as did singles, Congress

¹ This information is taken from and is discussed in greater detail in Note, *Federal Income Tax Discrimination Between Married and Single Taxpayers*, 7 Journal of Law Reform 667 (1974).

retained the pre-1969 singles' tax rate schedule as the schedule for married taxpayers filing separately. Because of continued inflation and other social pressures on women entering the market place, significant percentages of our married couples are two earner families. The only way to neutralize the discrimination against these individuals is to return to the pre-1948 single tax rate schedule.

JOINT AND SEVERAL LIABILITY

Along with the privilege of filing a joint return, Section 6013 of the Internal Revenue Code of 1954 (hereafter referred to as the Code) establishes joint and several liability for married taxpayers filing jointly. Where a return is filed by a married couple and one spouse does not pay the tax, the other spouse is fully liable for the deficiency.

For many years courts were forced to apply this rule in the harshest fashion even while they realized its inequities. Congress attempted to alleviate this situation in 1971 by enacting Section 6013(e) of the Code, also known as the "innocent spouse" provision. Generally, this rule benefits those individuals who signed a joint return and had no knowledge of the omission of income from the return.

Were this the extent of the innocent spouse provision, I might not be addressing this issue today. After all, if a husband or wife knew that his or her spouse had not reported their entire joint income, he or she is hardly an innocent spouse in the matter. By the same token, if both spouses in a two-earner family failed to fully report their income, they would both be guilty of fraud and misrepresentation.

I submit to you, however, that absurd results have arisen because of the requirements which must be met in order for a spouse to be relieved of any tax liability. First, a joint return must be filed in which the omission of income attributable to one spouse is in excess of 25 percent of the amount reported as gross income. Second, the spouse seeking relief must establish that he or she did not know nor had any reason to know of the omission. Third, this spouse must prove that he or she did not significantly benefit, either directly or indirectly, from the omission of income, and that it would be inequitable to hold him or her liable for the deficiency.

The legislative history of Section 6013(e) indicates that it was designed to bring tax collection practices into accord with the basic principles of equity and fairness. Unfortunately, practice and principle are still poles apart. Many truly innocent spouses are denied relief.

Most of these problems arise from judicial construction of specific terms. What, for example, is an "omission"? When will it be "inequitable" to hold an innocent spouse liable? The answers are far from clear.

A. Knowledge On The Part Of The Innocent Spouse

In order to be relieved from liability, the innocent spouse must establish that he or she had no actual or constructive knowledge of his or her spouse's activities. Where the spouse claiming innocence can be shown to have actual knowledge of this activity, such as knowing that income is being unreported, relief from liability will be denied. But what happens when there is no actual knowledge?

Courts have gone out of their way to prove that the spouse claiming innocence had constructive knowledge, that is, should have known, of the activity that generated the non-reported income. But they are not very consistent in their approach. Facts in a case that are determined by one court to rule out constructive knowledge will be viewed by another court as sufficient to establish constructive knowledge.

Constructive knowledge is as tangible as a will-o'-the-wisp. Take the case of *Ann J. Anderson*, 34 T.C.M. 508 (1975), who argued that the innocent spouse rule shielded her from tax liability for the years 1969 and 1970. The Tax Court ruled that in 1969, she had neither knowledge nor reason to know of her husband's illegal activities. However, she was found to have such knowledge in 1970.

For several years Mr. Anderson had been embezzling money from his employer. None of the embezzled funds were put into an account over which Mrs. Anderson had any control; they were kept in his business checking account. Despite the embezzled funds, their standard of living had not improved in either year. From these facts, the court concluded that Mrs. Anderson had no knowledge of her husband's activities in 1969.

In November of 1970, however, Mr. Anderson was indicted for embezzlement and pleaded *nolo contendere* in February, 1971. The plea of *nolo contendere* is

not an admission of guilt and because Mr. Anderson received suspended sentence from not less than four nor more than five years in jail, it seems clearly to be a reasonable plea bargain. The court placed great weight on the fact that Mrs. Anderson knew of her husband's activities upon his conviction which did not occur until February, 1971. Therefore, the court reasoned, she had knowledge of the unreported income in 1970.

Does an indictment alone give a spouse reason to know of omitted income? What if he or she can prove that no benefit was received? At first blush, a conviction would seem a solid indicator of reason to know of an omission of income. But what if the plea was bargained as *nolo contendere* to prevent a jail sentence? The accused has not admitted any guilt. There are numerous reasons why an innocent person may plead no contest, not the least of which is to avoid the expense of future litigation. The truly innocent spouse is harmed in cases like these.

The United States Court of Appeals for the Fifth Circuit added a new wrinkle to the picture in *Sanders v. United States*, 509 F.2d 162 (5th Cir. 1975). Even discounting unreported income of \$30,000, the Sanders enjoyed a high standard of living. With the unreported income added to the reported income, however, they bought a new home, new cars, traveled to Las Vegas and bought a new condominium in the Bahamas.

The court stated that "one person's luxury can be another's necessity and the lavishness of an expense must be measured from each family's relative level of ordinary support". Mrs. Sanders argued that she had no constructive notice of the unreported income because their standard of living had not changed; they would have made the purchases notwithstanding and had been living in that lifestyle for some time. The court agreed holding her not liable for the deficiencies.

What an absurd result! It appears that the person whose spouse might earn \$15,000 a year, does not report an equal amount, and expands the couple's lifestyle will be charged with constructive knowledge of an omission of income. On the other hand, the person whose spouse might earn \$50,000 a year, does not report \$15,000 and does not increase the couple's standard of living is not charged with constructive knowledge of an omission of income.

The more difficult it is for the Internal Revenue Service to identify the true nature of a transaction leading to omitted income, the more willing courts should be to grant relief to an innocent spouse. In *Robert L. McCoy*, 57 T.C. 732 (1972), Mr. McCoy incorporated a partnership whose liabilities exceeded its assets, an action which under the tax law results in income to the extent of such excess. Mrs. McCoy knew of the existence of the partnership but did not actively participate in the business. She claimed that she was unaware of the tax consequences of incorporating a deficit partnership and since the transaction did not realize a cash gain, had no reason to know of any income omitted from their joint return.

Common sense would indicate that because the transaction was a complex one, Mrs. McCoy would have no reason to know of the omitted income. But the Tax Court ruled otherwise: "mere ignorance" of the tax consequences did not relieve her from liability. This decision is completely at odds with other rulings which have held a spouse can have knowledge of some of the facts related to the unreported income without being charged with knowledge of the income itself. Many lawyers and corporate executives would not understand the tax consequences of such a transfer. How is a non-businessperson spouse supposed to?

B. Omissions—The 25 Percent Rule

1. Omissions.—To be relieved from liability, the innocent spouse must show that there was an omission from gross income "of an amount properly includable therein". If there is any reference in the joint return to the income in question, there can be no omission. For example, a common argument made by taxpayers is that denial of a claim for a deduction should qualify as an omission. Courts have almost uniformly held that since the deduction is on the return, it cannot be said the spouse claiming innocence was unaware of the omission.

But what happens where the examples of reference to income are carried out to its extreme? Take the case of *Estate of Klein v. Commissioner*, 537 F.2d 701 (2nd Cir. 1976). Mr. Klein was a partner in a business with a net partnership income of approximately \$90,845. This amount was listed in the partnership return, and only the net income from the partnership is included on a taxpayer's income tax return. Technically, however, the gross income of the partnership

is included in the partner's gross income, and if this larger number rather than the reportable net income is used, the omission did not amount to 25 percent of gross income.

In signing the joint income tax return, Mrs. Klein had no knowledge of the partnership business, had not reviewed the partnership return, had signed a return where partnership income was included as required at the net income figure of \$90,845 (not actual gross income attributable to Mr. Klein of \$1,106,896) and yet the Tax Court and Second Circuit held her liable because of a remote technicality of the law. If this is not absurd, read carefully the following statement of stipulated facts that the Second Circuit accepted in deciding the case:

The parties stipulated that she [Mrs. Klein] had met the further equitable requirements, namely that *she did not know of, and had no reason to know of the omission of income . . .* and that, taking into account all of the other facts and circumstances, including whether or not she had benefited either directly or indirectly from the omission, *it would be inequitable to hold her liable for the deficiency attributable to it . . .* (Italic supplied.)

The details of Section 6013(e) go against the purpose of the innocent spouse provision, which is concerned with equitable relief for an innocent spouse. As was noted in a recent law review article, "[T]he knowledge of an innocent spouse claimant should be important in determining 'equitable relief' . . . not the knowledge of the Internal Revenue Service."²

2. *The 25 Percent Rule.*—Even if the amount in question is determined to be an omission, it must be in excess of 25 percent of the gross income reported in the joint return. Working with this fixed figure, courts have been forced to make mechanical and clearly ridiculous applications of the law. The results are at times pathetically comical.

In *Wissing v. Commissioner*, 441 F.2d 553 (6th Cir. 1971), Betty Wissing (formerly Mrs. Huelsman) was married to a man who had embezzled more than \$100,000 over a 3-year period from his employer. The Internal Revenue Service determined a deficiency in their 1963 joint return of approximately \$7,291, \$2,027 in their 1964 return and \$15,871 in their 1965 return. The United States Court of Appeals for the Sixth Circuit found the amount omitted in 1963 and 1965 exceeded 25 percent of their reported gross income, but not in 1964. Therefore, Betty was liable for the 1964 deficiency, but not the 1963 and 1965 deficiencies.

The court admitted that Betty had no knowledge of her husband's activities and did not derive any benefit from the embezzled funds. But because she signed the joint return, she became jointly and severable liable for the tax due on any omission less than 25 percent of their reported gross income.

C. The Significant Benefit Test

In order to determine whether or not it would be equitable to hold the claimant spouse innocent, courts look to see if he or she significantly benefited, whether directly or indirectly, from the omissions. For the most part, courts have been liberal in granting relief under this test. For example, the Tax Court in *Patricia E. Mysse*, 57 T.C. 680 (1972) held that a spouse did not receive a significant benefit from over \$100,000 in unreported income which her husband had embezzled over a four-year period. According to the court, any benefit which she received from the funds constituted no more than ordinary support.

But look at the other side of the coin. In *Edward J. Jedinak*, 78 T.C.M. 958 (1978), Mr. Jedinak was involved in a numbers game which netted him substantial amounts of income that he did not report on a joint return. Although Mrs. Jedinak knew of this activity, she had no knowledge as to whether the income was reported or not. The court acknowledged that the amount in question exceeded the 25 percent test and that she did not know, nor had any reason to know, of the omission.

Nevertheless, the court found her liable for the tax deficiency. It appears that they jointly purchased stocks with some of this unreported income. This was found to constitute a significant benefit to Mrs. Jedinak, even though the court conceded that the benefit may not be actually realized for years. A similar result was reached in *Martin S. Schneider*, 77 T.C.M. 751 (1977) where a home was jointly purchased by husband and wife, even though the wife had no knowledge of the unreported income.

² James E. Panny and Marc L. Faust, *The Innocent Spouse Provisions Of The Internal Revenue Code: In Search Of Equity*, 32 University of Miami Law Review 137 (1977).

The inconsistency of the decisions in these cases are enough to stagger the imagination. In *Myssac, supra*, a woman who languishes in new cars and diamond rings is found to have received no significant benefit, but woman who are joint owners in property where benefits may not actually be realized for many years are deemed to have benefited significantly. Where is the logic behind this reasoning? Is this what Congress had intended in enacting the innocent spouse rule?

ALLOCATION OF INCOME IN COMMUNITY PROPERTY STATES

As I have already explained, a taxpayer claiming to be an innocent spouse must have filed a joint return. But what happens in community property states when married filing separate returns are filed? In these jurisdictions, income earned or attributable to only one spouse becomes part of the includable income of the other spouse, even if separate returns were filed. The Code states that "the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws . . ."

This section of the Code leads to interesting and frequently inequitable results. Let's consider the case of *Mildred L. Fehland*, 75 T.C.M. 1285 (1975) (formerly Mrs. Vandiver). In 1967, her husband earned approximately \$10,000 while Mildred earned approximately \$3,300. Because of marital difficulties, they filed separate returns that year. The Tax Commissioner determined that since the Vandivers lived in Texas, a community property state, she was liable for the tax on one-half of their adjusted gross community income, or approximately \$6,704.

Mrs. Vandiver argued that because she had no control over her husband's income, she should not be liable. Furthermore, she filed a separate return and therefore was not liable for the income.

The Tax Court rejected both arguments. In a community property jurisdiction, it noted, each spouse is liable for one-half of their combined income. At the same time, she could not rely on the innocent spouse rule because she had not signed a joint return. However, even the court had to admit, "[W]e realize that, given equal income interests vested in each spouse under the community property laws, certain inequitable situations that Section 6013(c) was designed to eliminate may very well arise if the spouses elect to file separately in community property states". (Italic supplied.)

Again, "Catch 22"! In order to avoid liability by filing a joint return, one spouse files separately even knowing that more taxes may be due only to subsequently find out that he or she is liable anyway for the misdeeds of the other spouse. It's the old familiar game of heads you win and tails I lose.

It can at least be argued (although not true in this case) that because the Vandivers were living together they were knowledgeable about each other's financial situation. But what about where the spouses are living apart from one another?

In *Bettie Jayne Coffman*, 33 T.C.M. 1416 (1974), Mrs. Coffman was separated from her husband during the tax year in question. Except for the fact that she had filed a separate return, all other requirements of the innocent spouse tax rule were met. Again, the Commissioner determined that she was liable for the tax on one-half of her husband's income. The Tax Court reluctantly agreed, holding that she could not invoke Section 6013(c) because separate returns were filed, yet was liable because Texas (their domicile) was a community property state. An identical result was reached in Texas just last May and several years ago in Louisiana.

SUMMARY

There is an old saying that everybody talks about taxes, but nobody does anything to improve them. It is incredible to me that the United States Court of Appeals for the Fifth Circuit was forced to adopt a rule contrary to all previous precedent to find an equitable way to solve problems similar to those I have discussed.

The case of *Aimce D. Bager* was consolidated on appeals with that of *Barbara M. Hansen, Bager v. Commissioner*, 603 F.2d 491 (5th Cir. 1979). Both women were married and resided in Louisiana. In the court's own words:

The IRS asserts that an income tax is due by a wife on one-half of her husband's unreported earnings—although she may have been living apart from her husband, had no control over his income, and no knowledge of what it was

or where it went. The plaintiffs are impoverished victims of their husband's profligacy. *The IRS has stripped clean one of the wives. The other is about to be stripped clean.* This horrendous result flows from Louisiana law, not federal tax law. (Italics supplied.) 603 F.2d at 494.

The facts are relatively simple. In *Bagur*, Mr. Bagur suffered extreme financial reverses in 1960. The court continued:

Mrs. Bagur knew there were financial problems but she did not know their nature or severity; Mr. Bagur never discussed his income or expenditures with his wife. Mrs. Bagur testified that there was no communication between them, even in 1960 and 1961 when they shared a house. After 1962 they rarely saw each other. She had no checking accounts or credit cards and did not own an automobile. All household bills were sent to her husband's office.

In 1962 the Bagurs' financial condition worsened. They received still another notice to vacate the house. Electricity, telephone, and gas were shut off. From 1962 until 1968, when Mrs. Bagur obtained a divorce, the taxpayer and her husband maintained separate domiciles in Louisiana. Mrs. Bagur lived in grinding poverty, often with the utilities cut off, sometimes with not enough to eat. Her three school-age children gave her a little financial assistance from time to time. Mrs. Bagur's health was poor; she was arthritic, anemic, and undernourished. Ground down but attempting to keep her head up, she worked sporadically in 1962, 1963, 1965, and 1966. Mrs. Bagur estimated that during the seven tax years in question her husband paid about \$10,000 for food, rent, and other necessities.

Finally, the Bagurs were judicially separated in 1968. As a result of the settlement of the community, following her divorce, she received a piece of property estimated as worth between \$2,000 and \$3,000.

The Commissioner reconstructed Mr. Bagur's net profit during 1960 through 1966 and assessed tax deficiencies against Mrs. Bagur based on one-half of her husband's taxable income. The Commissioner also determined that Mrs. Bagur was liable for the taxes on wages she received during 1962, 1963, 1965, and 1966. Because Mrs. Bagur earned these wages while living separately from her husband, they were separate property under Louisiana law. La.Civ.Code Art. 2334. She was taxed, therefore, on the entire amount earned. The Commissioner also assessed penalties against Mrs. Bagur for failure to file income tax returns without reasonable cause, I.R.C. § 6651(a); for negligent failure to pay income tax for the years 1960 through 1962, I.R.C. § 6653(a); and for underpayment of estimated tax for 1962, 1963, and 1966, I.R.C. § 6654. The total amount owing is \$3,860.27. The Tax Court held Mrs. Bagur liable for all the taxes and penalties assessed against her. 603 F.2d at 495, 496.

In *Hansen*, Barbara and Donald were married for 28 years. In 1971, Donald Hansen received commissions of \$34,500. The court continued:

It was a windfall. What happened to the money is a mystery. The Internal Revenue Service was unable to collect the deficiency. At the hearing before the Tax Court Mrs. Hansen represented herself. Counsel for the IRS informed the court that Mr. Hansen had been in dire straits. Mrs. Hansen added that her husband suffered from severe depression. We were informed during oral argument that Mr. Hansen had committed suicide.

Mr. Hansen was in charge of the household bills, many of which apparently went unpaid. He doled out cash to his wife to buy food and gasoline. She made "everything the [three] girls wore." (Tr. 10). As the daughters and two sons grew older they contributed small amounts to their support. In Lafayette Ms. Hansen had no credit cards. She gave up her checking account when her checks were returned for lack of sufficient funds. She signed her last tax return in 1963 when Mr. Hansen was salaried in Florida and she had a small job. When from time to time she questioned her husband about income tax returns, he used to say to her, "Don't worry about it. It's all taken care of." (Tr. 8). Ms. Hansen estimated that she and the children received about \$3,400 from her husband in the form of payments on their house, food, gas, and automobile upkeep.

For the children's sake, Ms. Hansen put up with her husband until 1972, when her youngest child was in high school. Ms. Hansen then instituted separation proceedings. She left the marriage with only a few household goods—no cash, no securities, no automobile. The mortgagee foreclosed the mortgage on the home. Ms. Hansen now works for the local telephone company.

The Commissioner determined that Ms. Hansen owed taxes on one-half of the income, \$34,500, her husband received in 1971. The Commissioner determined that Mr. Hansen incurred business expenses of \$5,000 and decreased Ms. Han-

sen's share of the community income by \$2,500. The tax deficiency assessed against her amounted to \$3,064. The Commissioner also assessed various penalties for Ms. Hansen's failure to file returns and pay taxes. Before the Tax Court, however, the Commissioner conceded that the penalties were not applicable. In the Tax Court hearing, Judge Sterrett showed signs of reluctance to hold against Ms. Hansen. Nevertheless, in 1977 the Tax Court sustained the Commissioner's determination that Ms. Hansen owed taxes on one-half of her husband's earnings in 1971. On March 6, 1978, the IRS notified Ms. Hansen that her wages were subject to a tax lien and would be seized to satisfy the deficiency. 603 F.2d at 496, 497.

The decision by the Court of Appeals to remand the case back down to the lower courts represented a victory to the taxpayers. An intent to deprive a wife permanently of her share of community income, the court held, may be inferred from a husband's wanton appropriation of her community assets in pursuit of his own pleasures or needs. The issue, the court stressed, is not whether the husband should be punished as a thief (which he could not under state law) but whether the wives should be allowed a tax loss as a victim of a theft under the federal tax laws. All previous precedent required that you look to local law to define "theft". Never has a court created a federal law of theft, something the Fifth Circuit found it had to do to prevent the injustices to the taxpayers before it.

The court ruled that it was for the lower courts to decide if the husbands had appropriated their earnings for their own purposes in such a way as to be equivalent to a theft of the wives one-half of the earnings. If this were so, the wives would be able to deduct as a theft loss this amount, thereby reducing their one-half of the joint income to zero and incurring no tax liability. Interestingly, to claim a theft loss, you must itemize your deductions. Wouldn't it be interesting to find a tax imposed because the taxpayer had insufficient itemized deductions?

In one motion the court established a method for community property taxpayers to escape liability for one-half of the community income. It took remarkable legal reasoning to reach a result that the overwhelming majority of people would consider the equitable result. How long must such machinations continue? They would not be necessary if taxpayers were liable only for the tax on their own earned income and capital income in relation to the contribution of each person to the purchase of the property.

RECOMMENDATION

It is my recommendation that we return to the pre-1948 single tax rate schedule for all taxpayers without regard to marital status or other status. Doing so would relieve many of the inequities that have arisen because of piecemeal efforts to prevent one group of taxpayers from obtaining some perceived advantage over another.

There should be a codification of the principle that earned income be taxed to the one who earns it. Income from property should be taxed to the owner of the property or in their respective proportions if the property is jointly owned. Since 1948, Congress, the courts and the Internal Revenue Service have devised sophisticated tests for determining the true owner. Rules can be worked out to handle the allocation of income with respect to any method of jointly holding property.

A return to the pre-1948 single tax rate would obviate the need for an innocent spouse rule, for there would no longer be any joint and several tax liability. Any problems that might arise with the single tax rate can certainly be overcome. A single return for married taxpayers could operate along the lines of the New York State tax return, that is, married taxpayers each file singly and pay the same rates as two single taxpayers. A method to allocate exemptions, deductions and credits can easily be developed.

H.R. 6824

[H.R. 6824, 90th Cong., 2d sess.]

A BILL To preserve the application of existing law to nonqualified deferred compensation arrangements maintained by tax-exempt organizations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the taxable year of inclusion in gross income of any amount covered by a nonqualified deferred compensation plan maintained by an organization which is exempt from tax under section 501 of the Internal Revenue Code of 1954 shall be determined in accordance with the principles applicable to deferred compensation plans maintained by other private organizations as set forth in section 132(a) of the "Revenue Act of 1978", approved November 6, 1978 (Public Law 95-600, 92 Stat. 2782).

BRIEF SUMMARY—H.R. 6824

PRESENT LAW

In 1978, the Internal Revenue Service issued proposed regulations¹ which provide generally that if, under a plan or arrangement (other than a qualified retirement plan), payment of an amount of a taxpayer's fixed, basic, or regular compensation is deferred at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, the deferred amount will be treated as received in the earlier taxable year. These proposed regulations would have applied to plans maintained by State and local governments, as well as plans maintained by tax-exempt organizations and taxable employers.

The proposed regulations were not finalized because the Revenue Act of 1978 contained provisions relating to deferred compensation arrangements maintained by State or local governments and by taxable employers.

With respect to plans maintained by a State or local government, the 1978 Act prescribed annual limitations and eligibility requirements under which amounts deferred by an employee or independent contractor are includible in income only when paid or otherwise made available to the employee or independent contractor (sec. 131 of the Act and Code sec. 457). With respect to a deferred compensation plan maintained by a taxable employer, the 1978 Act provided that the taxable year for inclusion of amounts deferred under the plan is to be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. It was intended that these principles are to be determined without regard to the proposed deferred compensation regulation under Code section 61 which was published in the Federal Register for February 3, 1978.

Neither of the provisions enacted under the 1978 Act dealt with the treatment of nonqualified deferred compensation arrangements maintained by tax-exempt organizations.

EXPLANATION OF THE BILL

Under the bill, the taxable year of inclusion in gross income by an employee of any amount covered by an unfunded nonqualified deferred compensation plan maintained by a tax-exempt organization is to be determined in the same manner as for a taxable employer. Thus, the year of inclusion would be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions in effect on February 1, 1978, and without regard to the Treasury regulations proposed on February 3, 1978.

¹ Prop. Regs. § 1.61-16, published in the Federal Register for February 3, 1978 (43 F.R. 4638).

EFFECTIVE DATE

The provision would be effective for taxable years ending on or after February 1, 1978.

REVENUE EFFECT

It is estimated that this bill would have a negligible effect on budget receipts.

STATEMENT OF AETNA LIFE AND CASUALTY CO.

Aetna Life and Casualty Company of Hartford, Connecticut is submitting this statement in support of enactment of H.R. 6824 which is currently being considered by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee.

As members of this Subcommittee, you are well aware of the recent regulatory and legislative history developed in connection with non-qualified deferred compensation plans. On February 3, 1978 the Treasury Department promulgated Proposed Regulation 1.61-16, which, if adopted in the form proposed, would have eliminated almost all deferred compensation arrangements. The publication of this proposal produced an avalanche of adverse comments. Subsequently, the issue was transferred to Congress where it was ultimately resolved for public and private sector employers under provisions set forth in the Revenue Act of 1978. This legislation, however, did not directly affect the non-qualified deferred compensation plans of tax-exempt employers. Following enactment of the Revenue Act, the Treasury Department, in June, 1979, reopened the comment period with respect to its originally proposed regulation for the purpose of securing additional comments from interested parties. It is our understanding that Treasury received over 1,000 letters in opposition to the regulation.

In November, 1979, Treasury held a formal hearing on this regulation and all sixteen persons scheduled to speak testified in opposition to the proposal. Since then there has been no formal activity by Treasury to resolve this issue. As a result, Treasury has created a de facto cloud over the heads of tax-exempt employers who wish to establish deferred compensation plans for their employees. We believe this is unfair and inequitable.

Aetna strongly supports passage of H.R. 6824 because both private sector and tax-exempt sector employers utilize such plans in precisely the same manner for precisely the same purpose: to attract and retain professional and management personnel. Within the tax-exempt community, deferred compensation plans have been established by hospitals, colleges and universities, country clubs, trade associations, co-ops, labor unions, etc. The common thread running among all of these organizations is the limited resources available to secure the services of talented people. Hospitals are particularly prone to the severe competition for both management and professional personnel. At a time when hospitals are making extraordinary efforts to contain costs, it has become increasingly difficult to provide sufficient compensation to executive directors, financial officers, and other management and professional personnel, while continuing to provide the services necessary to run such complex institutions. However, it is precisely during such budgetary squeezes that deferred compensation provides an extremely attractive alternative to attract and retain the most talented people available while, simultaneously, minimizing current expenditures.

The Treasury Department recently propounded two basic reasons to support its contention that deferred compensation plans for tax-exempt employers should be governed under a set of rules different from those applicable to private employers. The Department based its conclusions, first, on the so-called "tax tension theory" and, second, on its belief that the establishment of non-qualified deferred compensation plans results ineluctably in either the termination of or the reduction of qualified plan benefits. We believe that both arguments are purely theoretical and not supportable by existing facts or the experience of employers who have established such plans throughout the long history of non-qualified deferred compensation.

We seriously doubt that anyone, except the Treasury Department, has ever given serious consideration to the "tax tension theory" as a reason for not establishing a deferred compensation program. It has been Aetna's experience that the inability to currently deduct amounts set aside under such a plan has never

dissuaded a Private corporation which was seriously interested in attracting and maintaining a high level of executive talent from establishing such a plan. Furthermore, when a corporation, whether private or tax-exempt, purchases an annuity or life insurance contract to informally fund its obligation under such deferred compensation plan, the tax impact upon both corporations is identical, that is, the annual increases accruing under such contracts are not currently taxable to either the tax paying corporation or the tax-exempt corporation.

The Treasury's second major argument carries as little weight as its first proposition. Non-qualified deferred compensation plans have been viable fringe benefits, at least as far as the federal courts have treated such plans, for the last fifty years. At no time during this period, nor since 1900 when the Treasury Department finally acquiesced in the *Gates* case *James F. Gates*, 18 T.C. 570 (1952); *aff'd*, 207 F. 2d 711 (7th Cir. 1953), *acq.* (and prior nonseq. withdrawn) (1900-1 C.B. 5.) has anyone ever seriously suggested that deferred compensation plans caused employers to terminate or reduce benefits under existing qualified plans. Aetna has had ample opportunity to examine the reactions of private and tax-exempt corporations which have adopted deferral arrangements and we have failed to recognize the existence of such a phenomenon. Quite to the contrary, the concept of non-qualified deferred compensation has been utilized by most employers exactly as it was originally designed, that is, as a supplement to, rather than a substitute for, qualified plan benefits. As a major marketing organization for qualified and non-qualified deferred compensation plans in the United States, it has been our experience that the establishment of non-qualified deferred compensation plans has not had the adverse impact on qualified plans which has been suggested by the Treasury Department.

The Treasury Department has itself had ample opportunity to closely examine non-qualified deferred compensation over the last fifty years. Admittedly, it has not always been a willing participant in the development of this concept. However, since Treasury finally acceded to the viability of this concept in Revenue Ruling 60-31, it has issued several additional revenue rulings and numerous private letter rulings which further confirm the viability of deferred compensation plans. On February 3, 1978 the Department, through publication of L.61-16, again attempted to significantly curtail the concept of deferred compensation. Its effort resulted in the enactment of Revenue Act of 1978, in which Congress clearly and forcefully reestablished the concept of deferred compensation and totally vindicated private sector deferred compensation plans under Section 132 of the Act. Unfortunately, Congress failed to specifically address the tax-exempt sector although it is our understanding that this inaction was as a result of the normal give and take associated with Joint Conference Committee meetings.

We believe that the case for treating the deferred compensation plans of tax-exempt employers in the same manner as those established by private employers is overwhelmingly persuasive. On the other hand, the Treasury Department frankly admits that there are no apparent abuses associated with deferred compensation in the tax-exempt sector and, further, that there is no substantial revenue impact to the federal treasury. If enacted as introduced, H.R. 6824 will reaffirm the current state of the law, as represented by case law, revenue rulings and private letter rulings effecting tax-exempt employer deferred compensation plans exactly as Section 132 of the Revenue Act reaffirmed the law for private employer deferral plans. The bill will not change existing law. The Treasury Department, by opposing this bill, is effectively recommending that existing law be amended. The burden of proving this case lies directly with Treasury. We believe that it has failed to satisfy its burden and, accordingly, we strongly urge that this Subcommittee act favorably upon the bill.

AMERICAN ASSOCIATION OF FOUNDATIONS FOR MEDICAL CARE,
Potomac, Md., April 17, 1980.

Representative DANIEL ROSTENKOWSKI,
Rayburn House Office Building,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: This association fully supports H.R. 6824 which is pending before the Subcommittee on Select Revenue Measures. Our plea, which this bill addresses, is to preserve existing rules for taxing deferred compensation of employees of tax exempt organizations, subjecting them to the same treatment accorded private plans by the Revenue Act of 1978.

AAFPAC is America's national association for Individual Practice Association-type Health Maintenance Organizations (HMO/IPAs) and, as such, is the only national organization of its kind. Currently, 84 plans are active members of AAFPAC. Those federally qualified represent 10,940 participating physicians and have a combined enrollment of approximately 577,800. In addition, the original Foundations for Medical Care IPAs represent an approximate enrollment of 724,000 and 6,000 participating physicians.

This is particularly important to health maintenance organizations that are structured in the individual practice association mode (HMO/IPAs). Physicians who sign participating agreements with these HMOs agree to being on partial financial risk for their services and agree to have a certain percentage of their income withheld in order to moderate any loss that the plan may sustain. They also further agree to be bound by all of the utilization controls of the HMO/IPA.

The question often asked is, "why should they agree to these requirements"? The answer to this question is many faceted, much of it having to do with the desire to build competing health care delivery systems. One of the advantages to the physician for agreeing to participate in these programs has been the HMO's ability to offer deferred compensation programs. This is a real incentive not only to get the physicians to participate but to keep them in the plan since HMOs including HMO/IPAs have proved to be cost effective and are doing much to eliminate unnecessary expenditures.

Sincerely yours,

BOYD THOMPSON,
Executive Vice President.

STATEMENT OF THE AMERICAN COLLEGE OF HOSPITAL ADMINISTRATORS

The American College of Hospital Administrators is an international society comprised of 14,000 individuals involved in the profession of hospital and health services administration. While the majority of our membership is employed by hospitals (approximately 80 percent), a growing proportion is devoted to the administration of other health care delivery organizations and agencies (i.e., health maintenance organizations, nursing homes, community outpatient clinics, and health systems agencies—the health planning agencies established by Public Law 93-641).

Academic preparation for positions in hospital and health services administration now emphasizes a graduate (master's) degree from a specialized program. The vast majority of our membership who joined during the last 10 to 15 years possesses a master's degree. Our members have proven their expertise in this field through testing and experience criteria administered and evaluated by our organization.

There are more than 100 colleges and universities offering degrees in hospital and health services administration in America and their specialized curriculum serves to graduate well qualified professional administrators for today's complex health care facilities and organizations.

The American College of Hospital Administrators continues the education of its membership after graduation by offering a continuous series of seminars and educational programs throughout the country on a regular basis. We also publish a professional journal and other scholarly works. Admission and advancement in our organization is through the evaluation and testing of applicants and members through three classes of affiliation; nomineehip, membership, and fellowship. Thus, we serve both education and credentialing functions.

Cost containment in the delivery of health care in America is an important item in the overall war against inflation in which this country is engaged today. For the health care delivery system to function effectively it needs well trained and experienced administrators to manage America's health care facilities. Consequently, these professionally trained people need levels of remuneration and fringe benefit packages similar to those available to management personnel in private industry to motivate them to do the job that has to be done.

If compensation packages similar to those available in private industry are not provided to today's top level management personnel in the health care field, their incentive to choose the health care field, and to stay in the field as their life's work, will be greatly diminished. To the extent this would happen, the health delivery system would be seriously hampered, as would our country, in its quest for efficient health care and cost control in the delivery of health care services.

Currently, confusion exists with respect to deferred compensation plans for employees of non-profit organizations. The proposed regulations of the Department of the Treasury (DOT) to restrict the use of deferred compensation plans by non-profit organizations are distinctly discriminatory. If the DOT proposal to tax currently contributions to deferred compensation programs is applied only to employees in the non-profit sector, after legislative relief has already been provided private industry and the public service work force, this is certainly discrimination in its purest form. We wish to let it formally be known that the American College of Hospital Administrators is directly opposed to any discriminatory tax treatment against many of its membership and feels obligated to represent to the government, on behalf of its membership, our feeling.

Toward the end of eliminating this discrimination, we urge the subcommittee to act favorably upon H.R. 6824.

Thank you for this opportunity to present our views on this matter.

[Note: See also statement of American Council of Life Insurance, p. 160.]

AMERICAN FEDERATION OF LABOR
AND CONGRESS OF INDUSTRIAL ORGANIZATIONS,
Washington, D.C., April 25, 1980.

DAN ROSTENKOWSKI,
Chairman, Select Revenue Measures Subcommittee, House Ways and Means
Committee, Longworth House Office Building, U.S. House of Representatives,
Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The AFL-CIO is opposed to H.R. 6824. The bill would extend to tax-exempt organizations, the provisions of the Revenue Act of 1978 relating to nonqualified deferred compensation plans of private employers.

We see no reason why high salaried executives of tax-exempt organizations should be allowed to deliberately turn their backs on income when it is earned and thus select the taxable year when it will be most advantageous for them to report those earnings. Congress was correct not to include employees of tax-exempt organizations in the provisions of the 1978 Revenue Act.

At a time when both the Administration and the Congress are competing with each other to cut social programs and balance the budget, any negative effect on budget receipts caused by a tax break of this kind is particularly unjustified. We are pleased that the Administration has seen fit to "strongly oppose" H.R. 6824.

Unlike private employers whose deduction for salaries is postponed until the deferred amount is included in their employees' income, there is no deduction for salary payments in the case of a tax-exempt employer. For that reason, the Congress did not include tax-exempt organizations in the deferred compensation provisions of the 1978 Act. We see no reason to back-track on that decision.

Accordingly, the AFL-CIO urges the Subcommittee to reject H.R. 6824.

Sincerely,

RAY DENISON,
Director, Department of Legislation.

STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION

The American Hospital Association represents some 6,100 member institutions (including most of the hospitals in the country, extended and long-term care institutions, mental health facilities, and hospital schools of nursing) as well as more than 30,000 personal members. Our membership includes both for-profit and not-for-profit hospitals. We welcome the opportunity to present our views on H.R. 6824, a bill introduced by Representative Cotter to preserve the application of existing law to nonqualified deferred compensation arrangements maintained by tax-exempt organizations.

We would like to begin with a brief review of the legislative and regulatory history of this issue. The Department of the Treasury (DOT) issued a proposed regulation on February 3, 1978 which effectively would have eliminated all salary reduction deferred compensation arrangements. Following a substantial number of adverse comments on the regulation, Congress ultimately resolved the issue

by addressing the deferred compensation plans of public and private employers in the Revenue Act of 1978. Unfortunately, this legislation limited reference to tax-exempt employers by excluding them from the definition of private deferred compensation plans.

Following passage of the Revenue Act, the AHA and other interested tax-exempt organizations reviewed the regulatory options available to DOT. Although we were disappointed that the Act did not directly sanction tax-exempt sector deferred compensation plans, we reached two important conclusions: First, the Act's failure to address deferred compensation plans of tax-exempt organizations affirmatively did not represent any change in the existing body of case law and regulatory rulings pertaining to such plans; second, this omission did not provide DOT with a mandate to put in final form the February 3, 1978 proposed regulation limiting its effect to tax-exempt organizations exclusively. Unfortunately, in the early summer of 1979 DOT announced a second comment period on its proposed regulation, intent on imposing just such a limitation. The tax-exempt community demonstrated its total opposition to the proposed regulation by submitting over 1,000 letters of criticism. In addition, the AHA and other organizations testified in opposition to the proposed regulation at a public hearing held by DOT on November 27, 1979.

It is the earnest belief of the AHA at this time that the most reasonable resolution of this issue can be reached within a legislative framework, and legislation such as H.R. 6824 presents the most viable alternative.

PRESENT STATUS

Since DOT's public hearing last November, there has been no activity by that agency on this subject, nor do we believe there is any incentive for the Department to resolve the problem in the near future. In effect, the status quo works to the advantage of DOT and to the clear disadvantage of the tax-exempt community. By its inaction, DOT has effectively curtailed the use of deferred compensation by tax-exempt organizations. As a result of the Department's failure to withdraw its February 3, 1978 proposed regulation, substantial numbers of professionals in the health care field who might otherwise have participated in a deferral arrangement have elected to postpone their participation. We believe this consequence is grossly unfair and that it represents questionable use of the Department's regulatory authority. In the face of overwhelming opposition to its proposed regulation, DOT has worked its will without subjecting its regulatory position to public scrutiny and challenge. Independent of these considerations, we believe there are numerous and persuasive reasons why H.R. 6824 should be enacted into law.

EQUAL TREATMENT UNDER H.R. 6824

The bill proposes to treat tax-exempt employers, for purposes of non-qualified deferred compensation plans, under the same body of case law and regulations as for-profit sector employers are currently treated. We cannot stress strongly enough that the tax-exempt community generally, and tax-exempt hospitals specifically, compete directly and vigorously with the for-profit sector in the labor market. Not-for-profit and for-profit hospitals exist in the same social and economic environment; they serve the same public; they compete for the same types of skilled and scarce personnel in the same marketplace; and, except for the implications of tax status, conduct their business similarly. The proposed regulation draws a distinction which, we submit, is artificial. Because of limited resources, tax-exempt organizations are already unable to offer the wide variety of fringe benefit plans that their counterparts in the for-profit sector offer. This is an economic prohibition and not a legal prohibition.

Inasmuch as not-for-profit hospitals, particularly inner city institutions, have more restricted budgets and a greater volume of indigent patients, and since they cannot offer benefits such as profit sharing and stock options or other bonus plans, they are placed at a significant disadvantage if they are also precluded from providing deferred compensation on the same terms as investor-owned hospitals. In particular, many charitable inner city hospitals have great difficulty in attracting and retaining accomplished administrators, physicians and other professional personnel. With the loss of deferred compensation, these not-for-profit hospitals are placed at a further disadvantage. In order to meet the challenge of the for-profit sector for talent, not-for-profit hospitals should be able legally to make available the same type of deferred compensation arrangements that are offered by for-profit hospitals, without limitations or conditions.

NEGLECTIBLE FEDERAL REVENUE IMPACT OF H.R. 6824

The revenue impact experienced by the federal treasury from deferrals negotiated by employees of tax-exempt employers under H.R. 6824 would be miniscule, and the reason is quite simple. Enactment of H.R. 6824 would merely confirm the treatment currently accorded to tax-exempt deferred compensation plans under existing law. The bill would not create a new fringe benefit or new "loop-hole" that would create a drain on the federal treasury. Moreover, under non-qualified deferred compensation plans the payment of taxes is merely postponed, ultimately to be made by plan participants or their beneficiaries.

We have reviewed the figures for deferrals generated under the national AHA deferred compensation plan, beginning with its establishment in 1976. If it were assumed that all plan participants are in the 50 percent tax bracket—a far too liberal assumption; assumed also that the alternative to H.R. 6824 is the complete prohibition of deferred compensation plans for tax-exempt organizations (and not even DOT is suggesting this possibility); and further assumed that in the absence of deferred compensation plans, 50 percent bracket taxpayers will not participate in alternative investment programs, the total annual revenue theoretical gain to the federal treasury would be negligible.

Further, a closer examination of such deferral arrangements as they are utilized by hospitals has led us to conclude that even this insignificant gain in federal revenue could be substantially offset. It is extremely important to note that the establishment of deferred compensation plans by tax-exempt hospitals often represents an overall savings to tax-exempt employers. Such savings benefit not only the hospitals but, in the case of hospitals eligible to participate in Medicare and Medicaid, the federal treasury itself. It is well recognized that some deferred compensation plan participants in the 50 percent tax bracket—specifically, in our example, health professionals such as hospital administrators and physicians—will agree to forego a more substantial increase in compensation if they can postpone receipt of income until a later time, ordinarily at retirement when they are usually in a lower tax bracket. The employer's current cost is thereby reduced and, to the extent that a portion of such a plan participant's compensation is reimbursed by Medicare, the reduction of reimbursable hospital costs results directly in savings to Medicare.

COST CONTAINMENT

The hospital industry responded in November 1977 to the challenge of this Subcommittee's present Chairman to initiate an organized effort in the private sector to control rising health care costs, rather than have the federal government step in. As a result, the Voluntary Effort, which is the combined work of hospitals, physicians, insurers, manufacturers and suppliers, and consumers, has significantly reduced the rate of increase in total expenditures for hospital and Deferred compensation plans contribute to this cost containment effort. For example, a suburban Chicago hospital was able to reduce its costs by over \$100,000 in one year by renegotiating the contract through which emergency room service is provided and by offering those involved a deferred compensation program.

ANTI-INFLATIONARY IMPACT

Finally, we would like to suggest that a deferred compensation plan may represent a modest, localized anti-inflation program. Income which is deferred represents income which cannot be used currently to purchase consumer goods. Further, funds set aside under deferred compensation plans are ordinarily invested in annuity contracts, mutual funds, and savings accounts which are thereafter reinvested in many productive elements of private industry. Therefore, just as the energy crisis has demonstrated that the cumulative effect of numerous individual decisions to save fuel can significantly reduce total consumption, so too might passage of H.R. 6824 have a positive effect on the fight against inflation.

SUMMARY

In summary, we believe that removal of the cloud over tax-exempt sector deferred compensation plans would substantially increase the ability of not-for-profit hospitals to attract and retain qualified executives and professionals

to run and staff their institutions. The February 1978 regulation proposed (and not withdrawn) by the Department of the Treasury discriminates against employees and contract professionals serving not-for-profit hospitals. Moreover, many tax-exempt institutions are presently beset by the ravages of inflation, and rising costs are severely limiting the funds available to attract qualified talent. The availability to deferred compensation plans would greatly enhance their recruiting and retention efforts and would help contain costs. Containing costs directly affects the federal treasury by reducing reimbursements made to hospitals under Medicare and Medicaid. Further, H.R. 6824 would not adversely impact federal revenues since it would merely codify existing case law and regulations and would mandate that tax-exempt sector deferral arrangements be treated exactly as those adopted by other private sector employers. Finally, the pure simplicity of the bill is compelling. It would not create a complicated and lengthy addition to the Internal Revenue Code.

CONCLUSION

AHA is grateful to Representative Cotter and the members of the Subcommittee for their interest in the subject of deferred compensation for tax-exempt organizations. We appreciate this opportunity to present our views and respectfully urge that the members of this Subcommittee act favorably on H.R. 6824.

AMERICAN RED CROSS,
Washington, D.C., April 28, 1980.

MR. JOHN M. MARTIN, JR.,
Chief Counsel, Ways and Means Committee, Longworth House Office Building,
Washington, D.C.

DEAR MR. MARTIN: The American Red Cross is a nonprofit charitable and educational institution exempt from Federal income tax under Section 501(a), which has served the nation in a number of ways for nearly 100 years and is in fact a quasi-governmental organization.

In general, it endorses the statements made on behalf of the American Council on Education and the National Association of Independent Colleges and Universities in connection with these proceedings. For the reasons stated therein, we strongly urge the adoption of H.R. 6824 to confirm that a deferred compensation plan or agreement maintained by a tax exempt organization be governed by the same rules as the deferred compensation plans maintained by taxable employers. This should be done by amending Section 132 of the Revenue Act of 1978 (Public Law 95-600) to include deferred compensation plans or agreements maintained by tax exempt organizations. Under that section, the tax aspects of such plans are to "be determined in accordance with the principles set forth in regulations, rulings and judicial decisions relating to deferred compensation which are in effect on February 1, 1978." This means that the basic rules with respect to the taxation of deferred compensation agreements will be those set forth in Revenue Ruling 60-31, 1960-1 C.B. 174, a "discussion of the application of the doctrine of constructive receipt to certain deferred compensation arrangements." Revenue Ruling 60-31 was in turn based upon a number of decided cases. Some twelve of these, the earliest of which was handed down in 1921, were cited in the ruling itself. The validity of this ruling, which has been in effect for nearly twenty years, has been uniformly upheld by subsequent decisions of a number of courts.

In the recruitment of qualified personnel, the Red Cross, from time to time, faces similar problems to those outlined in the ACE and NAICU statement. Like them, it is in competition with taxable entities for unique individuals who have available to them in private industry many more incentives as well as levels of compensation which the Red Cross cannot provide. Included among these are the access to deferred compensation arrangements. While the Red Cross does not at the present time have a deferred compensation arrangement with any of its employees, it feels strongly that it should be in the same position as private industry to offer such incentive if it, as may well be the case, is the only means by which an individual can afford to join our staff.

Sincerely,

JOHN L. CURRIN, Counselor.

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING,
Washington, D.C., April 16, 1980.

Mr. JOHN M. MARTIN, Jr.,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building,
Washington, D.C.

DEAR MR. MARTIN: On behalf of the Association for Advanced Life Underwriting (AALU) and the National Association of Life Underwriters (NALU), we are submitting comments regarding legislation under consideration at the hearings held on April 17, 1980 by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means of the U.S. House of Representatives. The bill on which we wish to comment is H.R. 6824.

AALU is a national association of approximately 1,100 members who specialize in one or more fields of advanced life underwriting. Collectively its members are responsible for annual sales of life insurance in excess of \$2 billion, mostly in circumstances involving intricate, factual situations and often dealing with complex business planning.

AALU is affiliated with NALU, the largest life insurance industry field force organization in the United States. NALU is an association of regional and local organizations whose membership totals approximately 140,000 life insurance agents.

H.R. 6824, introduced by Congressman Cotter on March 17, 1980, would extend to organizations exempt from tax under section 501 of the Internal Revenue Code of 1954, the same treatment available for deferred compensation plans that is provided by section 132(a) of the Revenue Act of 1978 (P.L. 95-600). That is, H.R. 6824 would permit tax-exempt organizations to provide to their employees the same types of deferred compensation arrangements currently available to taxable business.

The Revenue Act of 1978 adequately addressed the perceived abuse that was occurring with respect to the use of deferred compensation. Recognizing that there was a problem with deferred compensation provided by state and local organizations, Congress provided special rules limiting the amount of deferred compensation provided by those organizations.¹ Also recognizing that there was no problem with deferred compensation provided by the business sector, Congress continued the existing law for those employers.² The Senate likewise recognized that tax-exempt organizations (other than state and local governments) did not contribute to the perceived abuses that Congress was addressing through section 457 of the Internal Revenue Code. Consequently, it provided for treatment of tax-exempt organization deferred compensation in the same manner as private taxable employers. Unfortunately, this provision was dropped in conference.

While we do not have any economic projections, we believe that the revenue effect of modifying the rules concerning deferred compensation agreements for employees of tax-exempt organizations would be insignificant. As a consequence, it is unlikely that revenue plays any material role in any decision regarding the treatment of deferred compensation by tax-exempt organizations. Congressman Cotter himself has also indicated that there is no documented abuse regarding the use of deferred compensation by tax-exempt organizations.³

We also believe that the purpose of tax equity would be significantly harmed by the creation of separate rules for employees of tax-exempt organizations, especially where those rules are not justified by any perceived abuse. From an employee's viewpoint, deferred compensation agreements should not differ in their tax result because of the tax status of the employer. A deferred compensation agreement for an employee of a private taxable employer should produce the same tax result for the employee as a similar deferred compensation agreement for an employee of a charitable organization. Separate rules exist for state and local governments but these rules resulted from perceived abuses (that do not exist in the case of tax-exempt organizations) and should not be extended beyond those situations.

Furthermore, because tax-exempt organizations must compete in recruiting employees with taxable organizations, it is important that the tax-exempt sector be able to offer the same compensation packages that are provided by the taxable business sector. To deny tax-exempt organizations the ability to provide compensation in the same way that taxable organizations can provide such benefits

¹ See section 457 of the Internal Revenue Code.

² See section 132 of the Revenue Act of 1978.

³ Statement by Congressman Cotter, Cong. Rec. E-1288 (Mar. 17, 1980).

is to put the tax-exempt organization at a competitive disadvantage in hiring. This should not be done unless there is a clear reason for discriminating against tax-exempt organizations in this fashion. To date, no such reason has been articulated by the Treasury Department or any other organization.

Consequently, AALU and NALU support an extension of the provisions of section 132 of the Revenue Act of 1978 to apply to tax-exempt organizations. The approach taken by Congressman Cotter in H.R. 6824 will properly correct the omission made as part of the finalization of the Revenue Act of 1978.

Respectfully submitted,

ASSOCIATION FOR ADVANCED LIFE
UNDERWRITING,
NATIONAL ASSOCIATION OF LIFE
UNDERWRITERS,
GERALD H. SHERMAN, *Counsel, AALU.*
STUART M. LEWIS,
Associate Counsel, AALU.

STATEMENT OF THE CLUB MANAGERS ASSOCIATION OF AMERICA, HORACE G. DUNCAN,
EXECUTIVE DIRECTOR

The Club Managers Association of America represents approximately 3,000 private membership club managers throughout the United States. For many of these managers a significant ingredient of their compensation is their unfunded deferred compensation arrangement with their tax-exempt employers.

Without deferred compensation agreements with their employer clubs, many of these managers would not have the security of any retirement plan. Many clubs could not afford to have funded pension plans because of the burden that would be placed on their members' dues, which for most clubs is their primary source of income.

The Internal Revenue Service issued proposed regulations in 1978 that provided generally that if, under a plan or arrangement, payment of any amount of a taxpayer's fixed, basic, or regular compensation is deferred at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, the deferred amount will be treated as received in the earlier taxable year. The proposed regulations would have applied to plans maintained by taxable employers and to tax-exempt organizations. They also would have applied to deferred compensation arrangements maintained by State and local governments.

The Revenue Act of 1978 provided relief for those employees with deferred compensation arrangements with taxable employers and those employees of State and local governments. With respect to plans maintained by State or local governments, the 1978 Act prescribed annual limitations and eligibility requirements under which amounts deferred by an employee are includible in income only when paid to the employee.

With respect to deferred compensation plans maintained by taxable employers, the 1978 Act provided that the taxable year for inclusion of amounts deferred under a plan is to be determined in accordance with the principles relating to deferred compensation set forth in regulations, rulings, and judicial decisions in effect on February 1, 1978.

The Internal Revenue Service is now considering adopting the onerous regulations proposed in 1978 but making them applicable only to tax-exempt organizations. Hearings were held on this modification by the IRS on November 27 of last year. Representatives of the Club Managers Association of America appeared at those hearings and vigorously opposed the adoption of the proposed regulations.

We urge you to approve H.R. 6824, introduced by Representative William R. Cotter (D-Conn.). The Cotter bill would preserve the application of existing law to nonqualified deferred compensation arrangements maintained by tax-exempt organizations. The bill would bring tax-exempt organizations, including tax-exempt clubs, within the definition of private organizations for the purposes of nonqualified deferred compensation plans. This is merely a continuation of existing rules and regulations of the Internal Revenue Service, and it is a sensible and simple solution of the problem.

We appreciate the opportunity to present our views on H.R. 6824.

[Mallgram]

CHICAGO, ILL., April 25, 1980.

Representative DANIEL RORTENKOWSKI,
House of Representatives,
Washington, D.C.

We understand that the Select Revenue Measures Subcommittee of the House Ways and Means Committee will soon review H.R. 6824, a bill designed to permit tax exempt organizations to offer deferred compensation arrangements. In addition to providing equity under the law for such institutions, the bill would no doubt assist in the recruitment of talented academic and administrative personnel. Your leadership in support of H.R. 6824 would be appreciated.

Sincerely,

MORTON C. CREDITOR, M.D.,
Interim Executive Dean,
University of Illinois College of Medicine.

INVESTMENT COMPANY INSTITUTE,
Washington, D.C.

HON. AL ULLMAN,
Chairman, Ways and Means Committee,
House of Representatives,

DEAR CHAIRMAN ULLMAN: The Investment Company Institute¹ submits the following comments in support of H.R. 6824, a bill designed to preserve the application of existing law to nonqualified deferred compensation arrangements maintained by tax-exempt organizations. The Institute supports H.R. 6824 for two reasons: first, the bill would greatly simplify an area of tax law which has become needlessly complex; and second, the bill would allow tax-exempt organizations to more readily compete with taxable organizations for capable personnel. Moreover, we do not believe that qualified employee benefit plans of tax-exempt organizations will be adversely impacted by passage of H.R. 6824.

Deferred compensation is simply remuneration for services, payment of which is made in a year subsequent to the year in which such services are performed. The recipient is not taxed on such amounts until payment is actually received and, in the case of taxable employers, the employer is not entitled to a tax deduction until that time. Prior to February 3, 1978, the concept of deferred compensation had been a well settled and widely recognized method of compensating employees. For tax purposes, the guidelines for establishing and maintaining plans of deferred compensation were based on decisions interpreting sections 61 and 451 of the Code or their predecessors. See, e.g., *Frank Conden, Sr. v. Comm.*, 289 F. 2d 2 (5th Cir. 1961); *Comm. v. Oates*, 20 F. 2d 711 (7th Cir. 1958); and *Ray S. Robinson*, 44 T.C. 20 (1963).

However, on February 3, 1978, the Internal Revenue Service published proposed regulations which would have applied the doctrine of constructive receipt to all arrangements where an employee has an individual option to defer the payment of compensation. Those regulations proposed that a taxpayer would be in receipt of compensation during a taxable year simply because there could have been receipt had the taxpayer chosen to structure his affairs differently.

In the Revenue Act of 1978, Congress prevented the application of the proposed regulations to employees of taxable entities and directed the IRS to continue to apply the pre-February 3, 1978 guidelines. In addition, the Act established a set of guidelines for nonqualified deferred compensation arrangements for individuals furnishing services to state and local governments. However, since tax-exempt organizations were not covered by the Act, they, absent legislation, will be subject to a third set of guidelines, namely Treasury regulations. Obviously, having three sets of rules governing nonqualified deferred compensation plans makes this area of tax law needlessly complex. We support H.R. 6824 because it will significantly simplify the rules governing these types of arrangements.

Deferred compensation is an important part of any compensation package offered to prospective employees. We see no reason why tax-exempt organizations should be restricted in this area as a matter of legislative policy. Indeed, tax-

¹ The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 322 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about \$89 billion, and have approximately 7.3 million shareholders. The Institute is a tax exempt organization as defined under section 501(c)(6) of the Internal Revenue Code and has a non-qualified deferred compensation arrangement.

exempt organizations often do not have the current income to offer salaries and bonuses equal to those of taxable entities. Further, tax-exempt organizations do not have the flexibility of offering compensation in the form of stock option plans and other similar types of plans. Yet these organizations need to attract capable management to operate successfully. Therefore, we support H.R. 6824 because it will aid tax-exempt organizations in competing with taxable organizations in the recruitment and retention of qualified personnel.

In his testimony on April 17, 1980, before the Subcommittee on Select Revenue Measures, Deputy Assistant Secretary of the Treasury Halperin seemed to imply that if H.R. 6824 is enacted, tax-exempt organizations which establish non-qualified deferred compensation plans will inevitably terminate, or reduce benefits provided to non-management personnel under qualified deferred compensation plans. We respectfully submit that Mr. Halperin's supposition is in error and fails to recognize the reality of employment practices. The Institute, for instance, has maintained generous qualified defined benefit and defined contribution plans for many years and has no intention of terminating them or reducing benefits. Moreover, we believe that qualified plans are an integral part of compensation packages for all levels of employment. Further, any entity, regardless of its tax status, that did not offer a qualified plan would be at a severe disadvantage in attracting and keeping employees.

In conclusion, the Institute supports H.R. 6824 because it will simplify the tax law concerning nonqualified deferred compensation arrangements and will aid tax-exempt entities in the recruitment and retention of qualified employees. In addition, we do not believe that the enactment of H.R. 6824 will have a negative impact on qualified employee benefit plans maintained by tax-exempt entities.

We would be pleased to discuss this or any related matters with your staff at their convenience.

Sincerely,

WILLIAM M. TARTIKOFF,
Assistant Counsel.

NATIONAL COAL ASSOCIATION,
Washington, D.C., April 10, 1980.

HON. DAN ROSTENKOWSKI,
Chairman, Subcommittee on Select Revenue Measures, Ways and Means Committee, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing in strong support of H.R. 6824, introduced by Representative Cotter to preserve the existing law which allows nonqualified deferred compensation arrangements between tax-exempt organizations and staff executives.

The attack last year by the Internal Revenue Service on these arrangements is completely unjustified and unfair. The proposed regulations would, if adopted, destroy certain deferred compensation plans used by many trade associations to attract qualified personnel. Legislation in the nature of H.R. 6824 is vitally needed to check the unwarranted action of the IRS.

Exempt organizations must be permitted to offer compensation packages competitive with for-profit organizations which have such recruitment and retention benefits as, performance incentives, bonuses, stock-option plans, ESOP's and other programs.

Executives of trade associations are a highly mobile group. Regardless of qualifications or performance, their job security often hinges upon frequently changing voluntary board leadership. This, of course, means that for many affected professionals future benefits flowing from a regular qualified retirement plan may become non-existent.

An exempt organization, even now, usually cannot compete on a straight salary basis with for-profit organizations or the federal government for highly-skilled professionals.

What few incentives exist for exempt organizations to attract qualified employees should not be diluted.

It seems patently unfair to discriminate against an individual solely because professional experience, training, or career selection has placed him in the non-profit sector.

For these reasons we urge that your Subcommittee approve H.R. 6824, and that the Ways and Means Committee favorably report the bill to the House.

I request that these comments be included as part of the hearing record.

Yours sincerely,

ROBERT F. STAUFFER,
General Counsel.

H.R. 7009

[H.R. 7009, 96th Cong., 2d sess.]

A BILL To amend section 117 of the Internal Revenue Code of 1954 to provide that Federal grants for tuition and related expenses at institutions of higher education shall not be includible in gross income merely because the recipient is required to render future service as a Federal employee

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 117 of the Internal Revenue Code of 1954 (relating to scholarships and fellowship grants) is amended by adding at the end thereof the following new subsection:

"(c) FEDERAL GRANTS FOR TUITION AND RELATED EXPENSES NOT INCLUDIBLE MERELY BECAUSE THERE IS REQUIREMENT OF FUTURE SERVICE AS FEDERAL EMPLOYEE.—

"(1) IN GENERAL.—If—

"(A) an amount received by an individual under a Federal program would be excludable under subsections (a) and (b) as a scholarship or fellowship grant but for the fact that the individual is required to perform future service as a Federal employee, and

"(B) the individual establishes that, in accordance with the terms of the grant, such amount was used for qualified tuition and related expenses,

gross income shall not include such amount.

"(2) QUALIFIED TUITION AND RELATED EXPENSES DEFINED.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified tuition and related expenses' means—

"(i) tuition and fees required for the enrollment or attendance of a student at an institution of higher education, and

"(ii) fees, books, supplies, and equipment required for courses of instruction at an institution of higher education.

"(B) INSTITUTION OF HIGHER EDUCATION.—The term 'institution of higher education' means an educational institution in any State which—

"(i) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate,

"(ii) is legally authorized within such State to provide a program of education beyond high school,

"(iii) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized health profession, and

"(iv) is a public or other nonprofit institution.

"(3) SERVICE AS FEDERAL EMPLOYEE.—For purposes of this subsection, service in a health manpower shortage area shall be treated as service as a Federal employee."

SEC. 2. The amendment made by the first section of this Act shall apply to taxable years beginning after December 31, 1980.

BRIEF SUMMARY—H.R. 7009

PRESENT LAW

Code section 117 provides that amounts received as scholarships at educational institutions and amounts received as fellowship grants generally are excluded from gross income. This exclusion also applies to incidental amounts received to cover expenses for travel, research, clerical help, and equipment. However,

the exclusion for scholarships and fellowship grants is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient. Educational grants are not excludible from gross income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Treas. Reg. § 1.117-4(c)).

Special legislation provides that members of a uniformed service participating in the Armed Forces Health Professions Scholarship Program, the Public Health Services program, and similar programs may exclude from gross income amounts received as scholarships under these programs. Participants in these programs must agree to work for their funding service after completion of their studies. This temporary exclusion will not apply to scholarships awarded students entering these programs after December 31, 1980. (This temporary exclusion was most recently extended by P.L. 96-167, enacted as part of H.R. 5224).

EXPLANATION OF THE BILL

The bill would provide that an amount, which is received by an individual as a grant under a Federal program and which would be excludible from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future service as a Federal employee, would not be includible in gross income if the individual establishes that the amount was used for qualified tuition and related expenses.

The excludible qualified tuition and related expenses would be the amount used for tuition and fees required for the enrollment or attendance of the student at an institution of higher education and for fees, books, supplies, and equipment required for courses of instruction at that institution.

The bill would define an "institution of higher education" as a public or other nonprofit educational institution in any State which: (1) admits as regular students only individuals who have a certificate of graduation from a high school (or the recognized equivalent of such a certificate); (2) is legally authorized within the State to provide a program of education beyond high school; and (3) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized health profession.

EFFECTIVE DATE

The exclusion provided by the bill would apply to taxable years beginning after December 31, 1980.

REVENUE EFFECT

It is estimated that this bill would reduce budget receipts by \$8 million in fiscal year 1981, \$17 million in fiscal year 1982, and \$21 million in fiscal year 1984.

ASSOCIATION OF AMERICAN MEDICAL COLLEGES,
Washington, D.C., April 29, 1980.

HON. AL ULLMAN,
Chairman, Committee on Ways and Means,
U.S. House of Representatives,
Washington, D.C.

DEAR Mr. ULLMAN: The Association of American Medical Colleges (AAMC) would like to take this opportunity to comment upon H.R. 7000, a bill to amend Section 117 of the Internal Revenue Code of 1954 to provide that Federal grants of tuition and related expenses at institutions of higher education shall not be includable in gross incomes because the recipient is required to render future service as a Federal employee.

The Association is gratified that your Committee is taking steps to develop a permanent resolution of the question of the tax status of various scholarship programs undertaken pursuant to Federal initiatives. This action will give taxpayers participating or contemplating participation in these programs and the institutions administering them a confident understanding of the tax consequences of such participation. However, the Association is disturbed at the lim-

ited nature of the exemption proposed by H.R. 7009 in that it will only apply to tuition and fees received. Furthermore, the Association is disappointed that the bill only provides for an exemption where the required service payback is for service as a Federal employee.

The Association is the national voice for all of the 126 operational U.S. medical schools and their students, more than 400 of the major teaching hospitals and over 60 academic and professional societies whose members are engaged in medical education, biomedical and behavioral research and in patient care; thus its deep interest in the proposal before your Committee.

The Association is concerned about the impact of the limitation of the tax exemption provided for in H.R. 7009 to that portion of the scholarship which is used for tuition and related expenses upon the attractiveness of participation in the National Health Service Corps (NHSC) and Armed Forces Health Profession Scholarship programs. Both of these programs are intended to address important national problems in the area of providing adequate health services—the NHSC is aimed at meeting the need for health services in health manpower shortage areas and the Armed Forces Program at insuring an adequate supply of physicians to meet the medical care needs of members of the military forces. The continuing concern of Congress about these health manpower problems is indicated by recent activities of several of its authorizing Committees—the Subcommittee on Health and the Environment of the House Committee on Interstate and Foreign Commerce has just completed markup of health manpower legislation which includes the NHSC Scholarship Program as one of the important means of addressing the problem of physician geographic and specialty maldistribution; the House Armed Services Committee has recently marked up a special pay bill to permit the Armed Forces to continue to attract sufficient numbers of physicians into their ranks. The Association respectfully urges this Committee to not take any action that would, even to a minor degree, serve as a disincentive to enter either the NHSC program or the Armed Forces program, both of which are so clearly in the national interest. Such a step would seem to contradict the current Federal policy in these areas.

On first blush, the actual effect of the exclusion of the stipend for living expenses from the proposed tax exemption would seem minor. An unmarried scholarship recipient with no other income would be taxed approximately \$310. This amount is, however, over 6 percent of living expenses received under these programs and thus is not an insignificant amount to the individual trying to make ends meet during these inflationary times. On the other hand, viewed from the perspective of the U.S. Treasury, the total amount of taxes to be received in its coffers under this proposal is minuscule indeed.

The Association also believes that it is shortsighted to limit the exempt status to include only those who are committed to serve in Federal employment. This would seem to exclude National Research Service Award (NRSA) recipients. NRSA is an extremely important health manpower training program. There is a continuing need for attracting the most creative aspirant scientists into the national research enterprise. Failure to define scholarships for the purpose of tax laws in such a fashion as to clearly include NRSA grants will serve as a true disincentive to enter research, especially for those pre-doctoral students who will be taxed on the full award, including that portion which represents tuition and fees. While it is true that NRSA fellows are not required to perform future service as a Federal employee, but rather may fulfill their obligation by engaging in health research or teaching, this kind of academic endeavor had been determined by Congress in creating the NRSA program to be of significant national interest—a kind of de facto Federal service. Incentives to enter such academic pursuits are badly needed to help encourage individuals to forego the considerably greater financial awards offered by the private sector. Furthermore, there is another service option available to some NRSA fellows in order to meet their service commitments which does involve Federal employment as defined by H.R. 7009. Those award recipients who are trained to provide health services may meet this obligation by serving in the National Health Services Corps or engaging in private practice in their specialties in a geographic area designated by the Secretary of the DHEW to require such specialties. Thus, despite the fact that students in the NRSA program may perform the exact same type of service commitment contemplated by the proposed measure they will not be eligible for the tax relief available under it. The Association strongly urges the Committee, at the least, to provide an extension of the present moratorium on the tax status

of awards under the NRSA program so that the Committee can further consider the implications of the exclusion of such awards.

In considering the appropriateness of either including the NRSA for eligibility for the tax exemption contemplated by Section 117 or continuing the present moratorium on taxation, the Committee should be aware that there exists a substantial question as to whether the Internal Revenue Service (IRS) was a correct in its determination that the Supreme Court holding in *Bingler v. Johnson*, 394 U.S. 741 (1969), required a finding that NRSA awards should be excluded from the definition of "Scholarships or Fellowships" contained in Section 117 of the Internal Revenue Code. In Rev. Rul. 77-319, I.R.B. 1977-35,7 the IRS held that NRSA awards are not excludable from the gross incomes of recipients under Code Section 117, on the ground that the condition imposed on the recipient for the awarding of the grant is a substantial quid pro quo from the recipient, in that in return for receiving the award, the recipient must perform services designated by the grantor.

The facts in *Bingler*, upon which the Supreme Court relied in finding a substantial quid pro quo were considerably more compelling than are the facts with regard to NRSA awards. Three of the factors upon which the Court relied are not at all present in the case of NRSA awards: the grantor, Johnson Company, was a for-profit corporation and the recipient had a pre-existing employment relationship with Johnson; there was a close relationship between the recipient's grant from Johnson and his prior salary; and the recipient's research related to the grantor's business. Finally, perhaps the most important factor in *Bingler* was that the recipient of the fellowship was required to return to work for Johnson upon completion of the fellowship. The IRS in its ruling on NRSA awards argued that while no employment relationship exists between the grantor, the Federal government, and the grantees, the services required are designed to accomplish a basic objective of the grantor and thus the NRSA awards fall within the exclusion from Section 117 mandated by the *Bingler* decision. In the opinion of the Association, the promise of NRSA recipients to engage in research or similar service is not the kind of quid pro quo within the contemplation or consideration of the *Bingler* case. The Federal government will not benefit as an employer from the fulfillment of the service obligation; rather the Nation as a whole will benefit from the participation of the NRSA recipient in the research enterprise. The Committee, by taking action now with regard to the NRSA program, would be correcting the erroneous interpretation of the law by the IRS.

In addition to a concern over the impact of this legislation on the viability of specific health manpower programs, the Association is also troubled about the precedent that would be set by the enactment of this bill with regard to the taxability of scholarships in general. These scholarship programs are intended in part, just as any scholarship program is, to enable students to pursue their educational goals. Whether an award is used entirely to defray tuition and related costs or in addition helps subsidize a student's living expenses has never been a subject of inquiry and is not a relevant factor in determining whether an award is a scholarship within the meaning of the Code.

The Association appreciates this opportunity to put forth its views on H.R. 7000. If the AAMC can be of further assistance to the Committee, please do not hesitate to contact me.

Sincerely,

JOHN A. D. COOPER, M.D.,
President.

BROWN UNIVERSITY,
DIVISION OF BIOLOGY AND MEDICINE,
Providence, R.I., April 15, 1980.

MR. JOHN MARTIN,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building,
Washington, D.C.

DEAR MR. MARTIN: Brown University wishes to be recorded as in support of H.R. 7000. This Bill is currently before the Committee on Ways and Means and if enacted, would provide for the permanent exemption of National Health Service Corps Scholarship awards from Federal Income Taxes.

Since scholarship recipients are required to repay these "grants", it would appear to be more equitable to treat these awards as non-taxable loans. In addition, payment of tuition and fees directly to health professions schools, rather

than to the students, removes these funds from the discretionary individual use which is generally implied for taxable income.

The Congress has established that the intent of the National Health Service Corps program is to attract health profession students to service in underserved areas. The imposition of Federal Income Taxes on the funds awarded via this program would tend to make the program less attractive to students. In addition, a tax on scholarship awards would fall disproportionately on students enrolled in private schools because of the significant tuition differential between public and private schools. Since private schools have consistently provided the larger numbers of students for the Corps, the imposition of a tax on such awards could seriously threaten this source of students.

Brown University is among that group of schools that has consistently presented the National Health Service Corps as a viable option to students. We would find it much more difficult to continue this practice if the awards to the students are made taxable.

Sincerely,

PIERRE M. GALLETTI, M.D., Ph.D.,
Vice President.

NATIONAL ASSOCIATION OF MEDICAL
MINORITY EDUCATORS, INC.,
Washington, D.C., April 15, 1980.

Mr. JOHN MARTIN,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building,
Washington, D.C.

DEAR MR. MARTIN: I am writing in support of HR 7000, a Bill submitted by Mr. Rostenkowski, currently before the Committee on Ways and Means. The Bill, if enacted, would allow a permanent exemption from Federal Income Taxes of the tuition and fees portion of the National Health Service Corps Scholarships.

We feel strongly that the proposed exemption is in the best interest of the nation, in that it makes the NHSC program more attractive to students than it is now. If the program is to meet the Congressional intent to attract the program, the more likely it is to meet the Congressional intent would be without such an exemption. It is reasonable to conclude that the more of providing sufficient numbers of physicians for temporary service is underserved areas.

Two other factors would appear to call for the exemption. First—the tuition and most fee charges are payable to the health profession schools and not to the students directly. In this regard, it does not appear to differ from other non-taxable scholarships paid to institutions on behalf of students. Indeed, the widely diversion tuitions in the nation's private vs. public schools would place an unusual and discriminatory financial burden on students at high tuition schools. Second—scholarship recipients are obliged to repay these "scholarships" through service. This would seem to make the funds more akin to loans, rather than scholarships.

On the basis of these considerations and in recognition of the fact that a significant fraction of the scholarship recipients are underrepresented minority students, NAMME urges the Congress to give favorable consideration to HR 7000.

Sincerely,

LEVI C. ADAMS,
President.